THE LAW OF CORPORATIONS

SUPPLEMENTAL READINGS

Class 11

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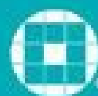
Corporations
and Other Business Entities

Seventh Edition

Steven L. Emanuel



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CORPORATIONS
AND OTHER BUSINESS ENTITIES

SEVENTH EDITION

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CHAPTER 6

THE DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

ChapterScope

This Chapter discusses a director's and officer's fiduciary duty to exercise due care when making decisions. Key concepts:

- **Duty of due care:** A director or officer must behave with the level of care that a ***reasonable person*** in similar circumstances would use.
  - **Personal liability:** If the director or officer is found to have breached this duty of care, in a way that causes loss to the corporation, he may be held liable for ***money damages***, which are to be paid to the corporation.
- **Business judgment rule:** The court will not find an absence of due care merely because the officer/director's decision turns out to have been an unwise one. The "business judgment rule" says that there's ***no breach*** of the duty of care where 3 requirements are met:
  - the director or officer had ***no conflicting self-interest*** in the matter that he decided;
  - he made himself ***adequately informed*** about the facts relevant to the decision; and
  - his decision was ***"rational"*** as of the moment it was made.

I. INTRODUCTION

A. The duty of care generally: This chapter considers the duty of directors and officers to ***act carefully*** when they act on behalf of the corporation.

B. Broad statement of duty: Stated in its broadest form, a director's

or officer's duty of care is as follows: He must, in handling the corporation's affairs, behave with the level of care that a ***reasonable person*** in ***similar circumstances*** would use. This sounds like the familiar negligence standard from tort law, and in many ways it is.

1. **Protection of "business judgment" rule:** However, a key rule called the ***"business judgment"*** rule in fact makes the duty of care much less burdensome than you might guess. Stated most briefly and generally, the business judgment rule says that courts will ***not second-guess*** the wisdom of directors' and officers' business judgments, and will not impose liability for even stupid business decisions so long as the director or officer (1) had ***no conflict of interest*** when he made the decision, (2) gathered a reasonable amount of ***information*** before deciding, and (3) did not act ***wholly irrationally***.

2. **Effect of combining the two rules:** When the duty of due care is combined with the business judgment rule, what we really have is a scheme that looks quite closely at the ***process*** by which the director or officer makes his decision, but then gives very little scrutiny to the substantive wisdom of the ***decision itself***. Thus a director who does not attend board meetings, or who acts without a serious attempt to obtain the available facts, is likely to be found to have violated his duty of care. By contrast, a director who tries hard, gets most of the available facts, and then makes a decision which is clearly unwise (even when viewed *without* the benefit of hindsight) probably will ***not*** be found to have violated his duty of care — the business judgment rule will protect him as long as his decision was not totally irrational.

C. **Liability for damages vs. injunction:** If a director or officer violates his duty of care to the corporation, and this violation causes loss to the corporation, the director/officer will be ***personally liable*** to pay ***money damages*** to the corporation. Often, this will come about procedurally by means of a shareholder's derivative suit (see *infra*, p. 318), in which a shareholder sues "on behalf of" the corporation against the negligent director or officer; if the plaintiff is successful, the director/officer will have to pay

damages to the corporation, and the shareholder/ plaintiff will share *pro rata* with all other shareholders by virtue of the corporation's recoupment of its losses.

1. **Injunction:** However, there is a quite different context in which the duty of care and the business judgment rule may also be relevant. This is the situation in which the board of directors has approved (but not yet consummated) a transaction, and a shareholder or outsider sues for an ***injunction*** to block the proposed transaction. If the court concludes that the directors or officers have not acted with due care, and that shareholders as a whole would be injured, it may block the proposed transaction until it is approved with the required level of diligence.

   a. **Easier decision:** In general, courts are probably willing to block a proposed transaction (especially in the takeover area) on less of a showing of a violation of due care than they would require before imposing personal liability on directors and officers. This is easy to understand: blocking a transaction that is unfair to shareholders probably will not directly (and certainly not unfairly) hurt the directors and officers who approved it, whereas making them personally liable for potentially huge damages as the result of their service to the corporation may severely hurt them, even bankrupt them.

D. **Only rarely happens:** In general, it is ***very rare*** for directors and officers to be found liable for breach of the duty of due care, as distinguished from breach of the duty of loyalty (discussed *infra*, p. 197). At least traditionally, most of the cases purporting to impose liability for lack of due care have probably really been cases in which the court believed that the directors were engaged in ***self-dealing*** (i.e., they violated their duty of loyalty), but because the proof of self-dealing was not strong enough, the court based its decision upon lack of due care.

1. **Modern trend:** However, beginning in the 1980s a few cases have found lack of due care even without indications of self-dealing. Therefore, the duty of care is becoming a duty that has some real practical impact upon how corporations are managed.

See especially the dramatic and instantly-landmark case of *Smith v. Van Gorkom*, *infra*, p. 186, in which the Delaware Supreme Court found the directors of a corporation liable for damages because they did not obtain the highest possible price from a takeover bidder, even though the sale price was substantially higher than the stock had ever previously traded, and even though there was no apparent taint of self-dealing.

E. Directors vs. officers: The duty of care is imposed on both ***officers*** and ***directors***. Essentially the same duty is imposed upon each. However, the duty that is imposed is the duty to behave reasonably "under the circumstances," and the circumstances are obviously somewhat different for an officer than for a director. For instance, an officer will typically have deeper knowledge about the company's affairs than will an outside director, so facts which might not give an outside director cause to investigate might give the officer such cause, making his failure to investigate a violation of due care even though the director's failure would not be. In general, everything we say below applies to ***both directors and officers*** unless otherwise noted.

II. THE STANDARD OF CARE

A. The basic standard: Virtually all states impose, either by statute or case law, a duty of ***due care*** on all officers and directors. The director or officer "must exercise that degree of skill, diligence and care that a ***reasonably prudent person*** would exercise in ***similar circumstances***." Clark, p. 123.

1. MBCA: The MBCA spells out this duty in a way that is typical of the law of most states: "Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith; and (2) in a manner the director ***reasonably believes*** to be in the ***best interests of the corporation***." §8.30(a).

2. No "accommodation" or "dummy" directors: An important consequence of this duty of care is that there is ***no such thing*** as an ***"accommodation"*** or ***"dummy"*** director.

Example: Suppose that X, who knows nothing about business, as a favor to his friend the President of ABC Corporation, accepts a director's post on ABC's board. President assures X that X will only be a "figurehead" who is not expected to have any significant function in ABC's affairs. Despite these assurances, a court will hold that X had a duty of care to ABC (and indirectly to its shareholders and creditors), and that he can be liable for damages if he does not act in accordance with this duty. "[A] person who accepts a directorship without assuming the responsibilities of a director is courting disaster." Nutshell, p. 310.

3. **Personal liability:** A director or officer who violates his duty of due care, and who thereby injures the corporation, may be held ***personally liable*** for the corporation's damages. This is true even if the director is paid little or nothing for his director's services, and otherwise had little or nothing to gain. In the case of a major corporation, the potential liability can be many times the director's net worth! (For this reason, most corporations now pay for directors' and officers' liability insurance. However, the existence of deductibles, co-insurance provisions and other limits means that even with insurance, a director is probably still significantly at risk if he violates his duty of due care.)

4. **Egregious cases:** However, this duty of due care is not as draconian as it might sound. First, under the "business judgment rule" (*supra*, p. 169), the actual business decisions made by a director or officer will not be second-guessed by the court as long as they are rational, made in good faith, and based on reasonable information. Therefore, liability for breach of the duty of due care generally arises only where the director or officer has failed to comply with reasonable ***procedures*** for making decisions. Second, even where the director's procedures are inadequate, most courts hold that there is only liability for ***"gross negligence***" or ***"recklessness."***

   a. **Total failure to act as director:** Therefore, most successful claims against directors have come in cases where the director simply ***fails to do the basic things that directors generally do***.

Thus a director might be found grossly negligent (and therefore liable) if he does some or all of the following:

[1] fails to ***attend meetings***;

[2] fails to ***learn anything*** of substance about the company's ***business***;

[3] fails to ***read reports***, financial statements, etc. given to him by the corporation;

[4] fails to ***obtain help*** (e.g., advice of counsel) when he sees or ought to see signals that things are going seriously wrong with the business; or

[5] otherwise "neglect[s] to go through the standard motions of ***diligent behavior***." Clark, p. 125.

Example: Mrs. Pritchard is a director of Pritchard & Baird, a reinsurance broker. Pritchard & Baird goes bankrupt, and its trustees in bankruptcy sue Mrs. Pritchard for violating her duty of due care as a director. They show that two officers of Pritchard & Baird, Charles and William Pritchard (who are the other two directors, are Mrs. Pritchard's sons, and are the sole other stockholders apart from Mrs. Pritchard) have misappropriated $12 million from trust accounts held by the company on behalf of others. During the years the misappropriation took place, Mrs. Pritchard was elderly, alcoholic, and depressed over the death of her husband. She hardly ever attended board meetings (which were in fact rarely held), knew nothing of the corporation's affairs, never read or obtained any financial statements, and in general "did not pay any attention to her duties as a director or to the affairs of the corporation."

Held, Mrs. Pritchard (and after her death, her estate) ***breached her duty of due care to the corporation***, and is therefore liable for the losses caused by the misappropriations. Directors are not required to conduct a detailed inspection of day-to-day activities. But they must at least become familiar with the fundamentals of the business, and must keep

informed in a general way about the corporation's activities. Here, had Mrs. Pritchard done even so little as to read the corporation's financial statements at any time, she would have noticed an item called "loans to shareholders" which dwarfed the company's assets, and which would have immediately put her on notice that her sons were effectively stealing trust funds. Had she noticed this, and asked her sons to stop, they probably would have done so (so that her negligence was a but-for cause of the losses). ***Francis v. United Jersey Bank***, 432 A.2d 814 (N.J. 1981).

b. Disguised "self-dealing" cases: Cases in which directors are held liable for failing to act with due care are often ***disguised "self-dealing" cases.*** That is, the court believes that the directors acted in pursuit of their own ends rather than for the good of the corporation, yet there is not enough evidence of this to make it the basis for the finding of liability; therefore, the court seizes upon lack of due care instead. Clark, pp. 126-28. For instance, in *Francis*, *supra*, the court was probably swayed by the fact that D was the mother of the two miscreants, and her refusal to undertake any of the responsibilities of a director may have been motivated in part by her desire to let her sons enrich themselves at the corporation's expense. See Clark, p. 127-28.

B. Subjective vs. objective standard: The standard of care is basically an ***objective*** one. That is, the director will be held to the standard of care that would be exercised by a ***"reasonable person"*** in the director's position. Consequently, a director who is simply less smart, less able or less innately diligent than an "ordinary" reasonable director will nonetheless have to meet this higher ordinary standard.

Example: Consider Mrs. Pritchard in the *Francis* case, *supra*, p. 172. Even though she was elderly, alcoholic and depressed over the death of her husband, these factors were not taken into account by the court in determining what level of care was "reasonable" for her. Instead, she was required to conform to the level of directorial skill and diligence that an ordinary

"reasonable" director would have shown under the circumstances.

1. **Special skills of director:** On the other hand, if the director has ***special skills*** that go beyond what an ordinary director would have, he ***must use*** those skills. For instance, if the director is by training an accountant, and he learns of facts which would make a trained accountant suspicious but would not raise the suspicions of an ordinary non-accountant director, he must behave as a reasonable accountant would behave under the circumstances. The rule would be similar for one with special ***legal***, ***banking*** or ***real estate*** training. Nutshell, p. 310.

C. **Surrounding circumstances:** The level of care required is that which is reasonable ***in the circumstances*** in which the director finds himself.

1. **Nature and size of business:** These "circumstances" include the ***nature*** and ***size*** of the particular business. For example, if the corporation is small and its operations relatively simple, the level of attention required of the director is probably somewhat less than if he sits on the board of, say, General Motors. Also, if the business serves as trustee or custodian for the ***funds of others***, probably a "reasonable" degree of care under the circumstances would include being on the lookout for misappropriation. Thus directors of banks are sometimes said to owe a "higher" standard of care; however, it would be more accurate to say that they owe the same "reasonable" duty of care as any other director, but that in a banking context this duty includes the obligation to be watchful for signs that depositors' accounts are being looted.

D. **Reliance on experts and committees:** Only rarely can a director, especially a director of a large corporation, directly ascertain the condition of the business. A director of IBM probably has no reasonable way to determine that the company's big supercomputer development program is way behind schedule, that its Singapore branch manager is fixing prices with his counterpart from Hitachi, or that the person overseeing the company pension plan is embezzling. Directors normally rely heavily on the ***expertise*** and

assurances of others, including the company's officers, lawyers, accountants and other persons who are in a better position to know the facts. Generally speaking, the director is ***entitled to rely*** on these other people, and is not expected to go behind what they tell him.

1. **Model Act:** Thus MBCA §8.30(b) provides that "(f) A director is ***entitled to rely*** … on:

   (1) one or more ***officers or employees*** of the corporation whom the director ***reasonably believes to be reliable and competent*** in the ***functions performed*** or the information, opinions, reports or statements provided;

   (2) ***legal counsel, public accountants***, or other persons ***retained*** by the corporation as to matters involving ***skills or expertise*** the director ***reasonably believes*** are matters (i) within the particular person's ***professional or expert competence*** or (ii) as to which the particular person ***merits confidence***; or

   (3) a ***committee*** of the board of directors of which the director is not a member if the director ***reasonably believes the committee merits confidence***."

2. **Reliance unreasonable:** On the other hand, it's vital to remember that the reliance must be ***reasonable***. Thus if the director knows facts which indicate that the officer, lawyer, or other third person is ***lying*** or is ***otherwise mistaken***, the director cannot bury his head in the sand and continue to rely on this third party's statements. As the MBCA puts it, the director may rely on the third party's statements, opinions, etc. (including financial statements) only so long as the director "does not have knowledge that makes reliance unwarranted[.]" §8.30(e).

   Example: X is the director of Corporation, a large construction contractor. There have been persistent rumors that high-level officials of Corporation have bribed foreign officials to get foreign construction contracts, in violation of the federal Foreign Corrupt Practices Act. The board appoints a special board committee to investigate; the committee comes back and reports that there is no substance to these allegations. Ordinarily, X would be permitted to rely on the committee's report, since he "reasonably believes the committee merits confidence" (see MBCA §8.30(b)(3)). But if X has actually been told by Y that Y and others have paid $10 million of Corporation's funds to Z to induce Z to give Corporation a

contract, X's reliance on the committee is no longer reasonable, because of this actual knowledge. Therefore, X may not hide his head in the sand and say, in effect, "Everything's okay because the committee says so." He must instead explain what he knows, and at least attempt to prevent recurrences.

a. **Tough standard for P to meet:** But it tends to be difficult for a plaintiff who is suing the directors to establish that the board's reliance on employees, experts, etc. was so unreasonable as to violate the duty of care. As we'll see in a little while (*infra*, p. 182), under the ***"business judgment rule,"*** if the board has no conflicts, is adequately informed, and merely makes a "rational" decision, that decision will not be deemed to violate the duty of care merely because it seems somewhat unwise or unreasonable after the fact. Therefore, the board's decision to rely on, say, an expert's recommendation will be protected under the business judgment rule ***so long as the board's procedures are reasonable***, even if the board does not make a very deep analysis of that recommendation before approving it.

Example: The Board of Walt Disney Co. ("Disney") approves an employment contract for Michael Ovitz, under which Ovitz is appointed president (number two) at Disney. The contract includes severance provisions under which if Ovitz is terminated without cause before the contract has run for seven years, Ovitz will receive a lucrative severance package. Ovitz in fact leaves by mutual agreement after 14 months, and ends up collecting the huge sum of $140 million in severance. In a derivative action, Disney shareholders sue the board, alleging that the board failed to use proper procedures in approving the contract, especially by failing to calculate how much severance Ovitz would receive in the event of an early no-fault termination. The complaint alleges that had the directors done such a calculation, they would have realized that the contract gave Ovitz a large incentive to exit the company by a no-fault termination as soon as possible.

The complaint also says that the board was negligent in relying on the advice of its compensation expert, Graef Crystal, who himself did not seem to have calculated how much severance Ovitz would be entitled to if he left early. The Ds (the directors) move to dismiss for failure to state a claim.

Held, for the Ds. Even if the board did, as alleged, fail to calculate the potential cost to Disney of an early no-fault exit by Ovitz, the allegation fails to create a reasonable doubt that this constituted lack of due care. "It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second-guess a board's decision, except 'in rare cases [where] a transaction may be so egregious on its face that the board approval cannot meet the test of business judgment.'" Here, the board's reliance on Crystal, despite Crystal's failure to fully calculate the amount of potential severance, lacks egregiousness. "[T]he duty of care is still filled even if a Board does not know the exact amount of a severance payout but nonetheless is fully informed about the manner in which such a payout would be calculated. A board is not required to be informed of every fact, but rather is required to be reasonably informed." ***Brehm v. Eisner***, 746 A.2d 244 (Del. 2000).

E. Passive negligence: In some situations, the duty of due care arises in connection with a specific, affirmative, action by the board of directors. Thus the board may choose to write a certain loan, approve a certain acquisition, or otherwise make an explicit decision to take (or not take) certain action. In this situation, it's not too hard to determine whether the board members have acted with due care. Many if not most situations, however, involve what might be called ***"passive"*** negligence, or "nonfeasance." That is, circumstances exist which the board (arguably) ought to notice and do something about, but instead the board members do nothing. Most commonly, this kind of situation arises when the board fails to ***detect wrongdoing*** by officers or employees of the corporation.

1. No duty to detect wrongdoing: The directors certainly do not have any explicit duty to ***in fact detect wrongdoing***. That is,

most courts would probably hold that the board members need not be suspicious sorts who go out of their way searching for evidence of embezzlement, bribery, self-dealing or other misconduct by operating-level managers or employees. As the Delaware Supreme Court has put it, "[A]bsent cause for suspicion there is no duty upon the directors to install and operate a ***corporate system of espionage*** to ***ferret out wrongdoing*** which they have no reason to suspect exists." *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963).

2. **Actual grounds for suspicion:** On the other hand, of course, if the directors are ***on notice*** of ***facts that would make a reasonable person suspicious*** that wrongdoing is taking place, their duty of due care requires that they at least ***investigate further***.

3. **Duty to put controls into place:** Furthermore, many courts today hold that, while the board's duty of care may not require it to install a "system of espionage to ferret out wrongdoing" (*Graham*, *supra*, p. 175), that duty of care *does* require that reasonable ***control systems*** be put in place to ***detect wrongdoing***, even where the board has ***no prior reason to suspect*** that wrongdoing is occurring.

   a. **Limited burden:** But once the board does put in such a control system, the board won't be liable for failure to supervise merely because the control system (and or the persons using it) ***fails to detect wrongdoing.*** The case in the following example demonstrates this.

   Example: Caremark is a medical services firm, which provides various forms of therapy — including treatments for HIV/AIDS and hemophilia — to outpatients. The company participates in various Medicare and Medicaid programs. A federal law, the Anti-Referral Payments Law (ARPL), forbids firms such as Caremark from paying doctors to refer Medicaid and Medicare patients to it. Caremark pays physicians fees for monitoring certain patients, including Medicare and Medicaid patients, that are under the firm's care. Federal prosecutors

indict the company on various felonies arising out of these monitoring fees, on the theory that the fees violate ARPL. The company settles these charges by pleading guilty to a single felony count, and then spends $250 million to settle various related civil claims against it. No senior officers or directors of the firm are charged with wrongdoing. Stockholders then bring a derivative suit on behalf of the company against all members of the Board of Directors, claiming that the board members failed to exercise their duty of due care, which (the suit asserts) required them to put in control mechanisms that would have prevented the violations of ARPL. The parties then propose to settle the suit, without the Ds paying any money, but with the company taking various steps to avoid future violations of law. The court is asked to approve the settlement.

Held, the settlement is approved. In deciding whether a settlement involving no financial recovery is reasonable, the court must of course take into account the likelihood that the plaintiffs would have prevailed at trial. Notwithstanding *Graham*'s statement about "espionage," "A director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and … failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."

However, the burden on a plaintiff who wants to establish a breach of this obligation is a high one: "only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability." Here, there is no evidence that the director Ds were guilty of such a sustained failure of oversight. The mere fact that the corporation committed a criminal violation does not by itself establish such a failure of oversight by the board. Since the Ps would be unlikely to prevail on the merits at trial, the

settlement is reasonable despite its failure to call for any financial recovery. ***In Re Caremark Int'l. Inc. Derivative Litigation***, 698 A.2d 959 (Del. Ch. 1996).

b. Approved by Delaware Supreme Court (*Stone v. Ritter*): *Caremark, supra,* was a decision by the Delaware Court of Chancery, not the Delaware Supreme Court. But in a later decision, the Delaware Supreme Court affirmed the basic test articulated in *Caremark* for when directors could be liable for an omission. In ***Stone v. Ritter***, 911 A.2d 362 (Del. 2006), the court cited *Caremark* approvingly, and said that, assuming the corporation has an exculpation clause (see *infra*, p. 178), the ***directors will have liability for poor oversight only if:***

"(a) the directors utterly ***failed to implement any reporting or information system*** or controls; or

"(b) having implemented such a system or controls, ***consciously failed to monitor or oversee its operations[,]*** thus disabling themselves from being informed of risks or problems requiring their attention."

i. Knowledge of shortcoming required: The *Stone* court then continued: "In either case [i.e., failed-to-implement-a-system or failure-to-monitor/oversee-the-system], imposition of liability requires a showing that the directors ***knew that they were not discharging their fiduciary obligations***."

ii. Gross negligence not enough: So what might be called ***"oblivious gross negligence" won't be enough*** for director-liability in Delaware, at least where — as is usually the case — the corporation has elected to put into its charter an exculpattion clause ***relieving directors of liability*** for violation of the ***duty of due care*** (see *infra*, p. 178). Unless the directors are ***conscious*** that they were not discharging their fiduciary obligations, ***no amount of inattention will be enough.*** As the Delaware Supreme court said in *Stone*, "a claim that directors are subject to personal liability for employee failures is 'possibly the most difficult theory in

corporation law upon which a plaintiff might hope to win a judgment.'"

iii. Illustration: The facts of *Stone* itself, set forth in the following example, illustrate how hard it is for the plaintiffs to recover — or even get to trial — on a claim in Delaware that the directors should be held personally liable for failing to detect employee wrongdoing. In particular, Delaware courts will be careful not to use the ***benefit of hindsight*** to infer that directors' failure to spot wrongdoing establishes that the directors behaved with the required conscious knowledge that they were not discharging their fiduciary responsibilities.

Example: The plaintiff shareholders in a derivative action (see *infra*, p. 318) allege that the directors of AmSouth, a Delaware-chartered bank, should be held liable for money damages because they failed to detect that the bank's employees were not filing Suspicious Activity Reports (SARs), required by federal anti-money-laundering statutes. (The bank paid $50 million in fines and penalties to resolve the government's SAR claims.) Special procedural rules concerning derivative suits require that in order for the case to go to trial, the plaintiffs must show a substantial likelihood that the directors knew, at the time the derivative suit was begun, that they faced possible personal financial liability from the suit. Since AmSouth has a charter provision exculpating directors for non-bad-faith breaches of the duty of due care (see the discussion of exculpation clauses *infra*, p. 178), the directors face financial liability if and only if they acted in "bad faith." The directors move to dismiss on the grounds that there is no evidence of their bad faith.

Held, for the directors. Where the claim is that the directors failed to make a good-faith effort to supervise the corporation adequately, the plaintiffs must establish bad faith by showing either that the directors utterly failed to implement a reporting or control system, or consciously

failed to monitor that system. In either case, liability requires a showing that the directors "knew that they were not discharging their fiduciary obligations." Here, there was unrebutted evidence that the board approved policies requiring the filing of SARs, and delegated to non-board employees the job of monitoring those filings and reporting back to the board about whether the policies were being followed. This is enough to rebut any claim that the directors knew they were not discharging their fiduciary obligations. "In the absence of red flags [which were not present here], good faith in the context of oversight must be measured by the directors' actions 'to assure a reasonable information and reporting system exists' and *not by second-guessing* after the occurrence of employee conduct that results in an unintended adverse outcome." *Stone v. Ritter, supra.*

iv. Significance: So in the usual case where a charter provision relieves the directors of money-damage liability for lack of due care, *Stone v. Ritter* establishes that directors of a Delaware corporation will have liability for failure of oversight only if they ***"knew that they were not discharging their fiduciary obligations."*** This is a ***nearly-impossible standard*** for the plaintiffs to meet — unless the plaintiffs can show that the board either (a) "utterly failed to implement *any* reporting or information systems or controls," or (b) "consciously failed" to monitor such a system once it was installed, the directors won't be liable, ***no matter how grossly negligent they were*** in failing to notice that wrongdoing was occurring.

c. Federal statute on controls: By the way, a federal statute now expressly requires that public companies institute a system of internal controls. §13(b)(2) of the Securities Exchange Act of 1934 now requires every publicly-held corporation to "devise and maintain a system of ***internal accounting controls***" to guarantee accurate financial statements and to guard against misappropriation of assets.

Most public companies have done this by creating an audit committee that works with the corporation's accountants to install such controls.

F. The significance of "good faith," and director-exculpation provisions in charters: The question of whether the directors satisfied their duty of due care is often intertwined with the question of whether the directors behaved in ***"good faith."*** For years, it was unclear whether the duty of good faith was an independent duty, or was instead an aspect of (1) the duty of care, which we've been discussing and/or (2) the duty of loyalty, which we will be discussing later (*infra*, p. 197).

1. Director-exculpation clauses: Why does it even matter whether the duty of good faith is an independent duty or part of some other duty (due care or loyalty)? At least in Delaware, the most important reason it matters has to do with the right of a corporation to ***reduce or eliminate a director's liability for money damages*** for certain claims. Del. GCL §102(b)(7) lets a corporation put into its certificate of corporation a provision "eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for ***breach of fiduciary duty*** as a director[.]" However, (b)(7) does ***not*** permit the reduction of liability for any breach of the "duty of loyalty" or for any acts or omissions "***not in good faith*** or which involve intentional misconduct or knowing violation of the law."

a. Claim of gross negligence as bad faith: Until 2006, plaintiffs in shareholder derivative actions (*infra*, p. 197) often argued in Delaware that if the board behaved grossly negligently, this gross negligence amounted to bad faith, and thus automatically deprived the board of the protections of a GCL §102(b)(7) clause, which most public corporations have in their charters. (For instance, the plaintiffs in *Stone v. Ritter*, *supra*, p. 177, made such a claim.) But in a series of three decisions by the Delaware Supreme Court, beginning in 2006, the court has held that only a narrowly-defined ***conscious disregard of duty*** — and ***not mere gross negligence*** — can amount to bad faith and deprive the board of the protection of

a §102(b)(7) provision. We consider these three decisions in Paragraphs 2 through 4 immediately below.

2. **Claim rejected in *Disney*:** First, in ***In Re The Walt Disney Co. Derivative Litigation***, 906 A.2d 27 (Del. 2006) (also known as the final opinion in *Brehm v. Eisner*), the Delaware Supreme Court said that ***gross negligence without more*** — even including a failure to inform oneself of available material facts — ***cannot constitute "bad faith"*** of the sort that deprives the directors of the protection of a GCL §102(b)(7) exculpatory clause.

   a. **Rationale:** The *Disney* court reasoned that the legislature, in enacting §102(b)(7), desired to afford "***significant protections*** to directors of Delaware corporations." To read the statute in a way that "conflates the duty of care with the duty to act in good faith by making a violation of the former an automatic violation of the latter, would nullify those legislative protections[.]"

   b. **Consequence:** Therefore, according to *Disney*, to qualify as the sort of bad faith that will deprive a director of the protection of the §102(b)(7) exculpation clause, a director's conduct must rise to the level of an "***intentional dereliction of duty***, a ***conscious disregard*** for one's responsibilities."[1]

3. **Failure of oversight:** Then, in ***Stone v. Ritter***, 911 A.2d 362 (Del. 2006), the court made it clear that this "gross negligence does not constitute bad faith" ruling covers claims that the directors ***failed to adequately supervise*** the corporation's operations. As we noted above (*supra*, p. 177), the directors will have liability for poor oversight only if they either:

   [1] "***utterly failed to implement any reporting or information system*** or controls"; or

   [2] "having implemented such a system or controls, ***consciously failed to monitor or oversee its operations[,]*** thus disabling themselves from being informed of risks or problems requiring their attention."

   Furthermore, the court said in *Stone*, neither of the above two

failures will be found to have occurred unless the plaintiff shows that the directors ***"knew that they were not discharging their fiduciary obligations***."

4. The "offer to buy the company" scenario: Then, in the last case of the trio, the Delaware Supreme Court held that this "gross negligence does not constitute bad faith" standard also applies to limit directors' liability for ***mishandling an offer to acquire the company.*** Only if the directors are shown to have "***utterly failed to attempt to obtain the best sale price"*** will they be liable for bad faith in the takeover context. ***Lyondell Chemical Co. v. Ryan***, 970 A.2d 235 (Del. 2009).

Example: The directors of Lyondell receive a $48/share buyout offer from Blavatnik at a substantial premium to the existing share price. Blavatnik says that this is his final offer, and must be accepted within one week or it will be off the table. During that week, the directors meet several time to consider the offer, solicit and follow the advice of their financial and legal advisors (which is to take the offer because it's higher than anyone else will likely pay), at least briefly attempt to negotiate a higher offer, and approve the agreement because they believe it's simply too good not to pass along to stockholders for their consideration. After the board accepts the offer and shareholders approve it, some investors bring a class action, alleging that the board showed bad faith in not doing more to get a higher price.

Held, summary judgment granted against the Ps. In the acquisition context, the directors will be liable for breach of the duty of loyalty only if they are shown to have "***utterly failed to attempt*** to obtain the best sale price." Here, the multiple board meetings, the soliciting and following of the advisors' advice to take the deal, and the members' belief that the offer was simply too good not to pass along to stockholders for their consideration, were more than enough to show that the directors did not fail to even attempt to obtain the best price. *Lyondell Chemical Co. v. Ryan*, *supra* (discussed further *infra*, p. 464).

5. **Summary of "gross negligence" vs "bad faith" in exculpation-clause cases:** Taken together, *Walt Disney*, *Stone v. Ritter* and *Lyondell Chemical* establish several propositions regarding director liability in the common situation in which the corporation has a §102(b)(7) exculpation clause:

   [1] Where there is an exculpation clause, the directors will ***not*** be liable for ***"gross negligence,"*** and will be liable ***only*** if they are shown to have acted in ***"bad faith."***

   [2] "Bad faith" requires a showing that the directors ***"utterly failed to [even] attempt"*** to discharge their fiduciary duties.

   [3] Consequently, where a Delaware corporation has an exculpation clause, it will take a ***very extreme fact pattern*** for the directors to be found liable for breach of the duty of loyalty, assuming the directors were not in a conflict position (see *infra*, p. 197). Essentially, the directors would have to have either (1) ***not even tried*** to discharge their responsibilities, or (2) been fully ***aware*** that the actions they were taking conflicted with their duties.

G. **Failure to make disclosure:** Under some circumstances, directors' or officers' ***failure*** to ***make accurate disclosure of information*** to shareholders may constitute a breach of the duty of due care.

1. **Shareholder action sought:** The most straightforward example arises when directors seek ***shareholder approval*** of some corporate action — when they do so, their duty of due care (as well as their duty of loyalty, see *infra*, p. 197) requires that they ***communicate truthfully*** about the merits of the proposed action.

   Example: Suppose that the board of X Corp. wants to merge the corporation into Y Corp., in a transaction in which X Corp. shareholders will end up with shares in Y Corp. Assuming that state law requires the board of X Corp. to obtain informed shareholder approval of the proposed transaction (as most states would require — see *infra*, pp. 378, 390), the board's duty of due care and loyalty would require it to exercise

reasonable care in disclosing to shareholders the facts needed for the holders to make an informed decision. For instance, suppose the board completely failed even to make reasonable efforts to ascertain, or to communicate to X's shareholders, the business prospects for a combined X Corp and Y Corp. A court might well hold that the board's failure to ascertain the facts and disclose them constituted a violation of the duty of due care, making the board liable in, say, a shareholder's derivative action (see *infra*, p. 318).

2. **Shareholder communication not required but given:** Now, however, suppose that the Board of Directors is ***not required*** to communicate with (or get approval of) shareholders on a particular matter, but chooses to do so anyway. If the board communicates incorrect information, can it be liable for a breach of the duty of due care? The Delaware Supreme Court answered "yes," in *Malone v. Brincat*, 722 A.2d 5 (Del. 1998).

   a. **Facts:** In *Malone*, the Ps were shareholders in Mercury Finance Co., and the Ds were directors of Mercury. The complaint alleged that the Ds intentionally and repeatedly overstated the financial condition of Mercury in reports to shareholders and the SEC, in breach of their state-law fiduciary duties. When the true facts were eventually disclosed, the share price collapsed.

   b. **Liability possible:** The court agreed with the Ps that liability was at least theoretically possible if the facts alleged in the complaint were proven. "When the directors disseminate information to stockholders when no stockholder action is sought, the fiduciary duties of care, loyalty and good faith apply. Dissemination of false information could violate one or more of those duties." (Because the complaint was poorly worded — the court couldn't even tell whether the claim purported to be a direct or a derivative one — the case was dismissed with leave to replead.)

   c. **Business judgment rule:** But it's unlikely that a mere error in reporting facts to shareholders would trigger a finding of

breach of the duty of due care. The business judgment rule would normally give the board significant protection in the case of an "honest," even if negligent, mistake. However, if the board failed to put into place ***reasonable procedures*** for ***gathering accurate information***, a breach of the duty of care might be found.

H. Causation: Even if a director or officer has violated his duty of due care to the corporation, many cases say that he will not be personally liable unless this lack of due care is the ***legal cause*** of ***damage*** to the corporation. In other words, in many courts the traditional tort notions of ***cause in fact*** and ***proximate cause*** apply in this context.

1. **Cause would have happened anyway:** Thus if the loss ***would have happened anyway*** even had the directors all behaved with due care, many courts hold that there is no liability.

2. **Delaware rejects:** But some states, including ***Delaware***, ***reject*** the requirement of causation when directors are shown to have violated their duty of care. Thus in *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) the Delaware Supreme Court held that once P shows that the directors breached their duty of care, that showing overcomes the protection that directors get from the "business judgment" rule (see *infra*, p. 182). At that point, P has established a *prima facie* case — ***even if he can't show that exercise of due care would have avoided the loss —*** and the ***burden of proof shifts to the defendants***: unless the defendants carry the burden of showing the "entire fairness" of the transaction, they will be liable.

3. **Joint and several liability:** When multiple directors are charged with breaching their duty of due care, each will (if she's smart) argue, "Even if I had behaved with due care, the rest of the board would probably not have listened to me, and the loss would have happened anyway." However, at least some courts hold that any board member who violates his duty of due care is ***jointly and severally liable*** with all other directors who have done so, as long as the board ***collectively*** was a proximate cause

of the loss; each director is treated as a "concurrent cause" of the harm, and is liable even though his own due care probably would not have made a difference. See ALI *Prin. Corp. Gov.*, §7.18, Comment d (taking "no position" on whether the liability should be joint-and-several or, instead, apportioned.)

III. THE BUSINESS JUDGMENT RULE

A. The rule generally: The "business judgment rule" may be thought of as a "judicial gloss" on what it means for a director to exercise due care. Even if the director's conduct might seem to lack due care when viewed from a general "reasonable person" benefit-versus-burden tort perspective, the more precise business judgment rule may save the director from liability.

B. Statement of the rule: There is no single universally-accepted statement of the business judgment rule. The basic idea behind the rule seems to be that "[business] decisions made upon ***reasonable information*** and with ***some rationality*** do not give rise to directorial liability ***even if they turn out badly*** or disastrously from the standpoint of the corporation.…" Nutshell, p. 310. In other words, the court will not find an absence of due care merely from the fact that the decision was ***unwise***.

Example: The Ds are the directors of American Express Co. They have caused the corporation to distribute the shares it holds in a separate company, DLJ, to shareholders as a special dividend. P, an American Express shareholder, brings a derivative suit against the Ds; he alleges that they should have had American Express sell these DLJ shares on the open market instead of distributing them as a dividend. He points out that this technique would have resulted in substantial tax savings to shareholders.

Held, for the Ds. P makes no claim that the Ds engaged in fraud or self-dealing. P is merely claiming that a different decision by the board would have been more advantageous. But a complaint alleging merely that some other decision would have been wiser does not state a cause of action,

because of the business judgment rule. ***"More than imprudence or mistaken judgment must be shown."*** Here, the evidence shows that the directors considered the tax advantages of selling the stock rather than distributing it, but were worried that this path would hurt the corporation's reported earnings; their decision will not give rise to liability so long as it was reached in good faith. *Kamin v. American Express Co.*, 383 N.Y.S.2d 807 (N.Y.Sup.Ct. 1976).

1. **ALI definition:** The clearest definition of the business judgment rule is perhaps the one given in the ALI's *Principles of Corporate Governance*:

> **§4.01(c)** "A director or officer who makes a ***business judgment*** in ***good faith*** fulfills the duty [of care] if the director or officer
>
> (1) is ***not interested*** in the subject of the business judgment;
>
> (2) is ***informed*** with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) ***rationally believes*** that the business judgment is in the best interests of the corporation."

a. **Interpretation:** Thus a director who asserts that he is protected by the business judgment rule has to prove three things under the ALI's approach:

[1] that he was not "interested" (i.e., that he had no ***conflict of interest***, no personal stake in the outcome that was different from the corporation's stake);

[2] that he gathered the reasonably needed ***information***; and

[3] that he honestly, ***and rationally***, believed that his decision was in the company's best interest.

So, assuming that the director has no conflicts and gathers adequate information, the essence of the business judgment rule is that ***mere rationality*** is ***all that is required*** — as long as the decision is not entirely crazy or outside the bounds of reason, the fact that (when judged by reference to the facts known to the director) it was ***very unwise***, will not be enough to make the director liable.

2. **Model Act:** The MBCA, by contrast, does not attempt to codify the business judgment rule at all. §8.30(a) sets forth the general duty of due care (including the requirement that the director act in a manner that the director "reasonably believes to be in the best interests of the corporation"). The Official Comment to §8.30 says that the elements of the business judgment rule, and its impact on the duty of due care, are left to the courts.

3. **Relation between general duty of care and the business judgment rule:** At first blush, the business judgment rule seems in conflict with the general duty of due care described above. Probably the best way to see how the pieces fit together is this: The duty of due care imposes a fairly stern set of ***procedural*** requirements for directors' actions — the director must act in good faith (e.g., not be pursuing his own interests), and he must get all reasonably needed ***information*** before deciding. Once these procedural requirements are satisfied, however, the business judgment rule sets out a far more easily satisfied standard with respect to the ***substance*** of the business decision: that decision will be upheld so long as it is "rational" (a weaker requirement than that the decision be "reasonable").

4. **Rationale:** There seem to be three main reasons for limiting directors' liability by use of the business judgment rule:

   a. **Risk-taking directors:** First, a certain amount of ***innovation*** and ***risk-taking*** is essential if businesses are to grow and prosper. It is generally in the shareholders' interests to have their directors take at least rational risks on the corporation's behalf. Without the business judgment rule, directors would become much more conservative and anti-risk, and the overall economic performance of corporations generally would probably decline.

   b. **Courts are poor judges of business reality:** Second, directors — like executives — must constantly engage in a ***"risk/return calculus."*** Judges, especially acting from hindsight, are ***not very good*** at making this kind of calculus — they have no training in it — so they may reach inappropriate

conclusions if we let them second guess business people. "A reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge." *Joy v. North*, 692 F.2d 880 (2nd Cir. 1982).

c. **Directors as poor "cost avoiders":** Finally, imposing greater director liability would make directors a form of ***"cost spreaders."*** But any given director is a poor cost spreader, since he probably serves only a few companies, and cannot incorporate the cost of his mistakes into the price he charges for his services. (This is in contrast to the ability of, say, lawyers or accountants to buy malpractice insurance and therefore spread among many clients the cost of law or accounting mistakes.) Shareholders can spread the risk of business misjudgments far more easily by diversifying their portfolios than directors can spread this risk by serving on multiple boards.

See generally *Joy v. North*, 692 F.2d 880 (2d Cir. 1982).

C. **Requirements for application of rule:** As we noted above, most courts appear to impose three requirements before the director or officer will gain the protection of the business judgment rule: (1) he must not have any private ***interest*** in the outcome different from the corporation's interests, i.e., there must be no taint of self-dealing; (2) he must have made the judgment only after gathering the reasonably needed ***information***; and (3) he must have ***"rationally believed"*** that his judgment was in the corporation's best interest. See ALI, Prin. Corp. Gov., §4.01(c). We now consider each of these requirements in turn.

1. **No self-dealing:** First, the director or officer will lose the protection of the business judgment rule if he has an ***"interest"*** in the transaction. Thus if he is a ***party*** to the transaction, or is related to a party, or otherwise has some ***financial stake*** in the transaction's outcome that is adverse to the corporation's stake, the business judgment rule will not apply. So any taint of ***self-dealing*** by the director will be enough to deprive him of the business judgment rule's protection.

a. **Rationale:** The rationale behind the business judgment rule is that we want to protect honest (even if mistaken) cases of business misjudgment. But if the director has engaged in self-dealing, he has not really engaged in business judgment (in the sense of judgment on behalf of the corporation) at all — instead he has been engaged in pursuing his own objectives. This conduct is not the kind of action we want to protect with a special rule that makes recovery very difficult. Clark, p. 138.

   Example: X is an officer and director of Printing Corp. He votes to have Printing Corp. purchase most of its paper from Paper Corp. Paper Corp. charges an average of 5% more for the same paper as is available, on substantially the same delivery and credit terms, from Discount Corp. Normally, X's decision to vote to have the purchases made from Paper Corp. would be protected by the business judgment rule (assuming that X acts with reasonable information, and his decision is not wholly irrational; see *infra*). However, it turns out that X is a secret substantial shareholder in Paper Corp., who will benefit financially by this large volume of business from Printing Corp. Therefore, X is "interested" in the transaction and he thus will not get the protection of the business judgment rule.

   Note: The law governing self-dealing transactions is discussed extensively beginning *infra*, p. 197, and is an extremely important body of law. The point we are stressing here is that self-interested transactions, unlike other transactions, don't get any special benefit from the business judgment rule.

2. **Informed decision:** The requirement that has the greatest practical importance is that the decision must have been an ***"informed"*** one in order to be protected by the business judgment rule. That is, the director or officer must have gathered at least a ***reasonable amount of information*** about the decision before he made it. As one court has put it, the directors must inform themselves "prior to making a business decision, of ***all material information reasonably available to them***." *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

a. **Gross negligence standard:** However, even with respect to his duty to become "informed," the business judgment rule is not as tough as it might sound. Most courts would probably hold that a director loses the benefit of the rule only if he was ***grossly negligent*** in the amount of information he gathered. In other words, mere "ordinary" negligence in obtaining available information, like mere negligence on the substantive merits of the decision, will not be enough to cause liability.

Example: Suppose that the directors of X Corp. are asked to approve X's acquisition of Y Corp. The President of X gives the directors ten years of financial information on Y, but director D only reads the last three years of this information. D (as well as his fellow directors) approves the acquisition, it goes forward, and it turns out disastrously because of embezzlements carried out by the founder of Y (who is kept on). Had D read the financial statement from seven years previously, he would have discovered in a footnote reason to doubt the honesty of the founder.

On these facts, a court would probably hold that D gets the benefit of the business judgment rule (thus validating his decision to acquire as long as it was not completely irrational) so long as he was not "grossly negligent" in limiting his reading to the three most recent years. Probably a court would find that while this limited research may have been negligent, it was not "grossly" negligent. See, e.g., *Smith v. Van Gorkom* (discussed extensively *infra*, this page), in which the court said "we think the concept of gross negligence is … the proper standard for determining whether a business judgment reached by a board of directors was an informed one."

b. **All circumstances considered:** In determining whether the decision was an informed one, the court will generally consider ***all of the surrounding circumstances***. For example, if the board's decision had to be made in an extremely ***short time period***, a smaller amount of information will have to be gathered than if the court had months or years in which to make the decision.

c. **The key case of *Smith v. Van Gorkom:*** The requirement that the decision be an "informed" one is the key to the most important business judgment rule case to be decided in modern times, ***Smith v. Van Gorkom***, 488 A.2d 858 (Del. 1985). *Van Gorkom* represents a striking exception to the usual rule that if there is no taint of self-interest, and at least some attention paid to directorial responsibilities, the business judgment rule will shield the directors for liability for their decision.

i. **Facts:** The precise facts of *Van Gorkom* are of utmost importance, so we consider them in detail. The Ds were the directors of Trans Union Corp., including its chairman/CEO, Van Gorkom. Trans Union was publicly-held, and Van Gorkom held a sizeable, but minority, stake. Van Gorkom was near retirement age, and apparently wished to sell his shares prior to retirement. He had his chief financial officer compute the price at which a leveraged buyout could be done; the CFO reported that at $50 per share, the corporation's cash flow would easily support a buyout, but that at $60 a share the cash flow might not be sufficient. Van Gorkom then, without consulting with anyone else in senior management, proposed to his friend Pritzker (a well-known corporate acquirer) to sell him the company for $55 per share. The company's price on the New York Stock Exchange had recently fluctuated between $29 and $38, and in its history had never been higher than $39 1/2. Pritzker agreed to a $55 per share buyout price.

ii. **Board approval:** Van Gorkom did not attempt to get any other offers for the company. Nor did he ever commission a formal study of the company's value. Instead, he went to his board of directors and asked them to approve the sale to Pritzker at $55. He did not invite the company's investment bankers to the board meeting. He told the board that Pritzker was demanding an answer within three days. Most members of senior management opposed the deal on the

grounds that the price was too low. The board was not shown the proposed merger agreement, or any documents concerning the value of the company; it relied solely on Van Gorkom's oral presentation, the chief financial officer's statement that the price offered was in the "low" range of appropriate valuation, and an outside lawyer's advice that the board might be sued if they failed to accept the offer. The board approved the buyout on this basis. The sale went through at $55 per share.

iii. **Holding:** The Delaware Supreme Court, by a three-two vote, held that the directors had been ***grossly negligent*** in failing to inform themselves adequately about the transaction that they were approving. The majority seemed especially influenced by the fact that: (1) it was Van Gorkom, not Pritzker, who promoted the deal and named the eventual sale price, and the board never ascertained this; (2) the board had made no real attempts to learn the "intrinsic value" of the company; (3) the board had no written documentation before it and relied completely on oral statements, mostly by Van Gorkom; and (4) the board made its entire decision in a two hour period, with no advance notice that a buyout would be the subject of the meeting, and in circumstances where there was no real crisis or emergency. (The board claimed that it had reserved the right to take any higher offer, but the court found that this reservation was illusory, because of tight limits that the Pritzker agreement placed upon the board's ability to accept higher offers from third parties. In any event, the two other bidders who came forward never made a serious offer, apparently in part because of limits placed on other offers by the board's deal with Pritzker.)

iv. **Dissent:** The two dissenters argued that the directors' decision to approve the merger should have been protected by the business judgment rule. One of them pointed out that the directors were highly sophisticated businessmen who were very well informed about the company's affairs.

v. **Significance:** The *Van Gorkom* decision is quite extraordinary. Here we have a buyout done at a price that was 40% above the highest price that the stock had ever traded for in its history. Yet the directors were held grossly negligent for approving the buyout! Perhaps the real key to the decision is that a majority of the court felt that the directors acceded to an autocratic leader (Van Gorkom), rather than making their decision in a collaborative manner. See Clark, p. 129.

vi. **Large stakes:** Observe that the stakes for the defendant directors in a case like *Van Gorkom* are enormous. Had the court finally decided that the buyout was $5 lower than a fully-informed transaction would have been done at, the 20 million shares outstanding would have produced a verdict of $100 million! In reality, the case was settled for $23 million (though this did not come out of the directors' pockets — about half came from directors' liability insurance and the rest from Pritzker, who apparently paid it voluntarily). S,S,B&W, pp. 714-15.

vii. **Lesser guilt:** Also striking is the fact that the other directors were held jointly and severally liable even though Van Gorkom was clearly the person primarily responsible for the transaction. The explanation is probably that the defendants pursued what turned out to be a poor litigation strategy: the court repeatedly asked them whether there were reasons to treat some directors differently from other directors, and they answered "no," preferring to pursue a "one for all and all for one" strategy. See Nutshell, p. 315; S,S,B&W, p. 714. Therefore, the court treated them as being jointly and severally liable.

viii. **Significance:** The *Van Gorkom* case seems most significant for the proposition that ***process*** is exceptionally important in obtaining the benefits of the business judgment rule. Had the board members reviewed the proposed merger agreement, and obtained an investment banker's opinion that $55 was a "fair" price, the court

would probably have found that the decision was an "informed" one, and was therefore protected by the business judgment rule. Thus the actual merits of the decision — whether $55 was an appropriate price — wasn't what really made the difference in *Van Gorkom*.

d. Takeover context: As *Van Gorkom* illustrates, directors must do more than merely "go through the motions" in approving major business transactions. Especially in the ***takeover*** area, the directors must go out of their way to gather all relevant information, must take whatever time is reasonably available in the circumstances before deciding, and must interrogate management closely rather than merely "rubber stamping" management's recommendations.

3. The requirement of a "rational" belief: The final requirement for the business judgment rule, according to most courts, is that the director must have ***"rationally believed"*** that his business judgment was in the corporation's best interest. See, e.g., ALI Prin. Corp. Gov., §4.01(c)(3). That is, the director must ***actually*** believe he is acting in the corporation's best interests, and this belief must be ***at least rational***.

a. Meaning of "rational": Observe that the requirement is merely that the belief in the soundness of the decision be "rational," not that it be "reasonable." In other words, so long as the belief is not ***totally beyond the bounds of reason***, it will be sustained even though most people might not have held that belief.

b. Refers to belief, not substance of decision: Also, keep in mind that what has to be rational is the director's *belief* that the decision is in the corporation's best interests, not the *decision* itself. Therefore, as long as the director (1) had a rational basis for believing that he had ***followed sensible decision-making procedures*** (e.g., he rationally believed that he had gathered the appropriate information before deciding), and (2) had a rational basis for believing that he was attempting to pursue the corporation's interests (rather than,

say, his own interests), that will be the end of the matter.

i. No scrutiny of merits of decision: An important corollary of this emphasis on the rationality of the "belief," not the rationality of the underlying decision, is that the court ought to focus on the directors' decision-making ***process***, and ***ought rarely to consider the merits of the underlying decision***. As one court has put it, "it is obvious that a court must examine the ***circumstances surrounding the decisions*** in order to determine if the conditions warrant application of the business judgment rule. If they do, the court will ***never proceed to an examination of the merits*** of the challenged decisions, for that is precisely what the business judgment rule prohibits." *Cuker v. Mikalauskas*, 692 A.2d 1042 (Pa. 1997). So, for instance, if the case arises in the form of a shareholder's derivative suit (see p. 318, *infra*), and the decision in question is the board's decision to terminate the suit, the court will never consider whether the suit itself had substantive merit, but will merely consider such procedural issues as whether the board or its sub-committee was "independent" when it made the dismissal decision, whether it conducted a reasonable investigation into the merits of the derivative suit, etc.

(1) No 20/20 hindsight: The idea that a court deciding whether to apply the business judgment rule should not review the substantive merits of the underlying decision is often captured by saying that the court ***will not use "20/20 hindsight."*** See, e.g., *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (discussed at length *supra*, p. 175): "It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second-guess a board's decision, except 'in rare cases [where] a transaction may be ***so egregious on its face*** that the board approval cannot meet the test of business judgment.'"

D. Exceptions to rule: Even where these three requirements for the business judgment rule are satisfied, there is at least one kind of situation (and possibly a second) where the court will find the rule

inapplicable.

1. **Illegality:** If the act taken or approved by the director is a ***violation of a criminal statute***, the director will ***lose the benefit*** of the business judgment rule. This is true even if the director was pursuing what he saw as the corporation's rather than his own interests, was acting based on full information, and rationally believed that his action would benefit the corporation (the three standard requirements for the rule). Even if there has been no criminal prosecution, if a civil plaintiff can show that the act was a criminal violation, the defendant will lose the benefit of the business judgment rule and his conduct will be evaluated solely based on the general duty of due care. (The director is then likely to lose, on the grounds that it is not due care to advocate or permit a violation of the criminal laws.)

    a. **Shareholders as protected class:** This "illegality" exception to the business judgment rule is especially likely to be invoked if the court concludes that shareholders are among the ***class meant to be protected*** by the criminal statute in question.

    Example: A statute forbids corporate charitable contributions. The purpose is to protect shareholders' financial interest. If a shareholder sues to recover illegal contributions, the court is likely to hold that the contributions violated the duty of due care if the board knew of them.Cf. *Miller v. American Telephone & Telegraph Co.,* 507 F.2d 759 (3d Cir. 1974).

2. **Pursuit of "social" goals:** Some courts recognize yet another exception to the business judgment rule: the pursuit by a director of broad ***social*** or ***political*** goals not related to the corporation's welfare. For instance, if the directors of a computer corporation (whose operations have very little to do with health care) were to donate, year after year, 50% of its net profits to a foundation for cancer research, a court might well hold that this extreme pursuit of social welfare goals at the expense of the corporation's profitability should not be protected by the business judgment rule. This might be the case even if the directors honestly, though

mistakenly, believed that such donations were in the corporation's best overall interests (thus perhaps satisfying the "rationally believes" requirement for the business judgment rule).

a. **Contrary view:** However, even in this kind of extreme situation, it is not clear that the court would refuse to apply the business judgment rule. Courts tend to give extremely ***wide latitude*** to directors' judgments that charitable or social (and perhaps even political) purposes mesh with the corporation's own financial interests. In any event, the corporation will usually be able to dress up its decision into one that is at least rationally related to the corporation's own financial interests.

Example: P, a minority stockholder in the Chicago Cubs baseball team, brings a stockholders' derivative action against the directors of the team. P alleges that one of the Ds, Philip Wrigley (owner of 80% of the stock) has refused to allow lights to be placed in Wrigley Field, not because he thinks this will benefit the corporation but because he holds the personal social/political opinion that "baseball is a daytime sport" and that the installation of lights will have a bad effect upon the surrounding neighborhood.

Held, for Wrigley and the other defendant directors. It is not clear that these motives, even if proven, are contrary to the best interests of the corporation and its stockholders. For instance, if the neighborhood around the park were to deteriorate because of lights, the value of the corporation's property (the park) would deteriorate; also, patrons might be less willing to come to the park if it were now in a deteriorated, poorer, neighborhood. (The fact that all other teams have implemented night baseball is irrelevant, because "it cannot be said that directors, even those of corporations that are losing money, must follow the lead of the other corporations in the field.") *Shlen-sky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968).

IV. MODERN STATUTORY MODIFICATIONS TO THE RULES OF DIRECTOR LIABILITY

A. Reason for statutory modifications: As the number of suits successfully holding directors liable for breach of the duty of due care has multiplied, many states have tried to ***counteract*** this trend by modifying their statutes. In general, these states appear to feel that increasing directors' and officers' risk of personal liability does not improve the economic efficiency of business as a whole, and certainly does not improve a state's ability to induce corporations to choose that state as their domicile.

B. Some typical approaches: There are at least four approaches that states have taken to reduce the practical burdens of director liability for money damages for breach of the duty of due care:

1. **Allow shareholders to amend charter:** Some states have allowed the shareholders to ***amend the corporate charter*** to eliminate or reduce directors' personal liability for violations of the duty of due care. For instance, Delaware GCL §102(b)(7) allows the shareholders to modify the corporation's charter to eliminate money damages for breach of the duty of due care, so long as the director has acted in good faith without knowingly violating the law and without obtaining any improper personal benefit. (For more about this provision, see *supra*, p. 178.)

2. **Looser standard of care:** Some states have made the ***standard of care*** looser, so only more egregious conduct will give rise to personal liability. For instance, Indiana and Ohio now allow recovery only where the director has intentionally harmed the corporation or acted "recklessly." See Ind. Code §23-1-35(1)(e)(2); Ohio Code §1701.59.

3. **Limiting damages:** Some states have placed a ***limit*** on the amount of money damages that may be recovered against the director or officer. For instance, in Virginia personal liability is generally limited to $100,000 (or any lesser sum put in the company's charter by shareholder vote). Va. Code §13.1-692.1.

4. **Greater right to indemnify:** Finally, many states now allow

the corporation to completely ***indemnify*** directors and officers for any liability they may have for breach of the duty of due care. This topic is discussed extensively *infra*, p. 341.

See generally S,S,B&W, pp. 734-736.

Quiz Yourself on
THE DUTY OF CARE & THE BUSINESS JUDGMENT RULE
(ENTIRE CHAPTER)

43. Teddy Roosevelt is chairman of the board of a Delaware-chartered linen supply company, Bully Sheet, Inc. The board of directors is thinking of paying a dividend to the shareholders. (The directors are aware that the jurisdiction, like most, prohibits dividends when the effect would be to leave the corporation unable to pay its bill.) The directors therefore call in the company's chief financial officer, Ben Counter, who tells them that paying the dividend would not affect Bully Sheet's ability to meet its financial obligations. The directors are somewhat surprised by this, since they know that the company hasn't met its payroll recently. Nonetheless, relying on Counter's report, they go ahead and declare a dividend.

(a) A shareholder subsequently brings a derivative action against the directors, trying to hold them liable for improperly paying the dividend at a time when the corporation could not in fact afford to pay it. The directors defend by claiming that they satisfied their duty of care by relying on the opinion of an expert, Counter. Who's correct? _____________________________

(b) What could the board and shareholders of Bully Sheet do to make sure that future claims like the derivative claim in (a) could not possibly succeed? _____________________________

44. Carlo Bonaparte is majority shareholder of the Elba Real Estate Development Corporation. His two sons, Napoleon and Joseph, are minority shareholders, as well as officers and directors of the corporation. When Carlo dies, he leaves his interest in Elba to his widow, Letizia, who also becomes a director. Napoleon, as President, asks for board approval of the use of $1 million of corporate funds to attempt to acquire the island

of Sardinia from an unaffiliated third party. In a 3-hour board meeting to consider the acquisition, Letizia and Joseph ask a number of questions, to which Napoleon gives answers that seem at least superficially reasonable. The board also reads a report on the proposed acquisition prepared by the company's accountants; the report concludes that the acquisition will probably be profitable, and that the price, though high, is within a reasonable range. At the conclusion of the meeting, Letizia says, "Well, I'd prefer that we stockpile our cash rather than going into this somewhat risky venture, but Nappy, if you really think it'll work out ok, I'll support you despite my doubts, because you've got a good feel for these real-estate purchase deals and I trust you to make money for the company."

Joseph votes against the acquisition, but between Letizia and Napoleon the proposal has enough votes to pass. A typical reasonably-able real estate investor would probably have voted against the transaction, because the price was about 25% above prevailing prices for such property, and the financial risks were clearly visible. The acquisition proves disastrously unprofitable, and causes the company to go broke. Joseph sues Letizia, alleging that she violated her duty of due care in voting for the acquisition.

(a) If you represent Letizia, what doctrine would you assert as a reason for holding Letizia not liable? _____________________________

(b) If you make the argument referred to in part (a), what will be the likely result of the suit? _____________________________

45. Lillian "Mama" Carlson is chairman of the board of Cincinnati Communications, Inc., (CCI) whose sole asset is radio station WKRP. Lillian rules WKRP with an iron fist, dominating the other seven board members — her son Arthur, Andy Travis, Jennifer Marlowe, Les Nessman, Venus Flytrap, Herb Tarlek, and Dr. Johnny Fever. Sosumi Inc., a giant Japanese communications company, offers to buy CCI for $50 a share. CCI is currently trading on the NYSE at $39 a share. Lillian wants to accept the offer, but realizes she needs board approval. At a special board meeting called on one day's notice, Lillian makes a 20-minute presentation about the offer. She doesn't supply — and the directors don't request — a valuation study or a written copy of the purchase terms. After her presentation, and with very little discussion, she

calls for a vote. The directors unanimously approve the sale. They submit it to a shareholder vote shortly thereafter, with their recommendation. The shareholders approve it. Thereafter, a minority shareholder, Bailey Quarters, sues the directors for violating their duty of care to the corporation, asserting that the value was closer to $80 a share. (Assume that Quarters is correct, that another bidder could have been found who would have paid $80.) The directors claim that their decision is shielded by the business judgment rule. What's the likely result?

____

46. Frank N. Stein wants to incorporate in Delaware his business, Frankie's Body Shop, which sells cadavers to be used in medical research. In order to lure qualified directors to his board, he agrees to put a clause in the articles of incorporation attempting to insulate the directors from breaches of the duty of care.

(a) Assume that the clause says, "No director shall be liable for money damages of any sort, arising from the violation of the duty of due care, regardless of the nature of the act or omission giving rise to the violation." Will the clause be enforceable as written?

____

(b) Assume that the clause says, "No director shall be liable for money damages arising from the violation of the duty of due care, so long as the director acted in good faith, without knowingly violating any statute or other law, and without obtaining any improper personal benefit." Will clause be enforceable as written? ______________________________

Answers

43. **(a) The shareholder.** Directors can violate their duty of care through inactivity, as by failing to inform themselves of their corporation's business. They typically can fulfill their duty to keep themselves informed by relying on the advice of experts, such as lawyers and accountants. However, reliance on third parties shields the directors from liability for failure to exercise due care only when the reliance is ***reasonable***. Reliance is not reasonable where the director is on notice of facts or circumstances indicating that the expert is wrong. [174] Here, the

directors know that Bully Sheet hasn't met its payroll recently; this flies in the face of Counter's statement that the company could pay a dividend and still meet its financial obligations. Once on notice of facts suggesting that Counter's statement was unreliable, the directors had at least a duty to inquire further, a duty that they did not discharge. Since the payment of the dividend in these circumstances seems to have brought harm to the corporation (by making it further insolvent), the directors are likely to be required to reimburse the corporation for the improperly-paid dividend.

(b) Placing an exculpation clause in the corporation's certificate of incorporation. Del. GCL §102(b)(7) lets a corporation put into its certificate of incorporation "a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director[.]" The provision can't cover a breach of the duty of loyalty or good faith, but it can cover a breach of the duty of care. Since only the duty of care is involved here, such a provision would make it virtually impossible for a shareholder derivative suit to succeed on these facts.

44. (a) You should assert that the "business judgment rule" bars liability. Under the business judgment rule, a director (or officer) who makes a business judgment in "good faith" fulfills the duty of care if the director (1) has no conflict of interest concerning the transaction; (2) is reasonably well-informed about the transaction; and (3) rationally believes that the business judgment is in the corporation's best interests. [183] You can make a pretty plausible case that Letizia's decision to vote in favor of the acquisition satisfied these requirements (see part (b) below).

(b) Letizia will probably win. As to requirement (1), there's nothing in the facts to indicate that Letizia had any conflict of interest regarding the transaction (for instance, the purchase was made from an unaffiliated third party.) As to requirement (2), the long board meeting, Letizia's detailed questions, and her reliance on the accountant's report, seem enough, taken collectively, to have made her "well-informed" about the acquisition. As to (3), Letizia's belief that Napoleon knew what he was doing seems to have been at least "rational," even if not fully "reasonable." Therefore, Letizia probably qualifies for the protection of the business judgment rule. If the court agrees, it won't hold Letizia liable

even though an ordinary director of reasonable prudence would probably not have voted in favor of the transaction, based on the facts then known to the board.

45. **The directors will probably lose.** Directors have a duty of care toward the corporation, which they can violate either through inactivity or negligence. The directors will be protected from even a bad business decision under the business judgment rule, if they meet the three requirements described in the previous answer. The problem is that here, the directors have almost certainly not met requirement (2), that they be reasonably ***well-informed*** before taking the action. The fact that the directors didn't have a valuation study or see a copy of the acquisition agreement, the shortness of the advance notice to directors, the lack of discussion at the meeting — all of these things indicate a lack of reasonable information on the part of the board.

    Since the board doesn't qualify for the protection of the business judgment rule, the question becomes whether the board's decision demonstrated "due care" or reasonable prudence. If another buyer really could have been found to pay $80, selling for $50 probably wasn't reasonably prudent. Therefore, the board will probably be held liable to reimburse the corporation for the money that was left on the table. See *Smith v. Van Gorkom*, so holding on roughly the same facts. [186]

    Note that, had the directors not been procedurally careless — i.e., had they deliberated and done a valuation, but honestly, mistakenly valued the corporation too low — the business judgment rule probably *would* have protected their decision. (The prior question is an example of how this protection might have applied.)

46. **(a) No, probably.** Delaware, like most states, will not allow a corporation to nullify the duty of care as completely as this clause purports to do. In particular, this clause would absolve a director from liability even if he knew that the corporate action he was approving violated the law, or even if the director was engaging in self-dealing, and most state courts, including Delaware's, would not allow such a complete waiver of liability. See Del. GCL §102(b)(7), listing a number of wrongs to which an exculpation clause may not apply, including an act or omission that violates the director's "duty of loyalty," that is "not in good

faith," or that involves "intentional misconduct or a knowing violation of law."

(b) Yes. Because this clause requires good faith, and doesn't apply if the corporate action is known to be illegal or constitutes self-dealing, the clause meets the requirements of Delaware law (and probably that of most jurisdictions). See Del GCL §102(b)(7), discussed in part (a) above. [190]

Exam Tips on ***THE DUTY OF CARE & THE BUSINESS JUDGMENT RULE***

The duty of care — and its sibling, the business judgment rule — are two of the most frequently-tested subjects. Be alert to these issues whenever a fact pattern involves a decision by an officer or the board which could be characterized as ***unwise***.

- ☛ Never consider "duty of care" in the abstract — always discuss it in ***conjunction*** with the ***business judgment rule***. In other words, phrase the initial issue as "did the directors exercise due care?" but then say something like, "If the conditions for the business judgment rule are met, the court will find that the board satisfied its duty of care even though the transaction turned out badly or seems to the court to have been substantively unwise."
  - ☞ Remember the ***three things*** a director must do to ***qualify*** for the business judgment rule:
    - ❑ she must ***not*** be ***"interested"*** (i.e., have a ***financial stake*** apart from the corp's own interest) in the subject matter of the action;
    - ❑ she must be ***reasonably informed*** about the decision she's making; and
    - ❑ she must ***rationally believe*** that the judgment she's making is in the ***best interests*** of the corp.

☞ Remember that ***absent directors*** are held to the same standard as directors who attended the meeting during which the board approved of a particular action. Thus if the board as a whole violated the duty of due care (i.e., didn't qualify for the business judgment rule), the absent directors will also be liable.

☞ Most frequently-tested aspect of the bus. judg. rule: the directors don't make an ***adequate investigation*** before they ***commit large sums of money*** to a project.

Example: Pres., the head of Corp., wants to sell Corp. to Acquirer. Pres. is worried that the present demand for Corp.'s products will be transitory, and believes that the most favorable sale would be one that is accomplished rapidly. Therefore, Pres. urges the Corp. board to approve the sale without debate, and does not fully brief the board on the reasons why Acquirer's offer is the best one that can be gotten. Nor does Pres. or the board have an outsider review the price or other sale terms. The board probably does not qualify for the bus. judg. rule, because it was not adequately informed. If so, the board will be liable for failure to satisfy its duty of care, if its carelessness caused a disadvantageous sale to be made.

- ☞ A variant is that a report describing the proposed transaction is prepared, but some directors ***don't read it*** — these directors don't get the protection of the bus. judg. rule, because they haven't taken the available steps to make themselves "reasonably informed."

- ☞ Questions sometimes involve board ***reliance*** on the ***opinions of others***. Here, the rule is that the board is entitled to rely on others where it is ***reasonable*** to do so. For instance, the board can typically rely on the opinion of the corp's CPAs, if the latter say that a proposed acquisition is a profitable business that is being sold for a standard multiple of earnings.

☞ Also, check whether the directors have acted in ***good faith.*** The requirement of good faith has two main components:

- ☞ First, the directors must have acted in a ***non-self-interested manner***. If they are acting so as to further their own business interests, at the expense of, say, a minority holder, the directors will

not qualify for the bus. judg. rule.

Example: The board refuses to pay out any of $5 million of accumulated earnings as dividends. P, a minority holder, sues to overturn this refusal, and the majority directors defend on the grounds that their dividend policies are protected by the bus. judg. rule. If P can show that the directors' purpose was to "freeze out" P — by depriving him of income so that he'd sell his shares back to the majority at a low price — the directors won't receive the protection of the bus. judg. rule.

☞ Second, the directors ***must not have been aware that they were not discharging their fiduciary obligations.*** (Cite to *Stone v. Ritter* on this point.) At least in Delaware, this means that the directors must have put in some sort of reporting or information system, and must have believed that they were doing some sort of monitoring of data from that system.

☞ A fact pattern will ***rarely fail*** to meet the ***"rational belief"*** requirement for the bus. judg. rule. Remember that so long as the directors' belief that the action was in the corp's interest is not ***wholly irrational***, this prong will be deemed satisfied. And this is true even if the action results in ***financial loss*** to the corp.

Example: To prevent a minority s/h from acquiring control, Corp. buys shares from 3 other s/h's at the asking price of $80/share, a price in excess of both book value and market value. As long as the decision was "plausible," the fact that the judge disagrees about the decision's wisdom — or the fact that later events showed that the shares were not worth the price paid — won't prevent the bus. judg. rule from applying.

1. “Subjective bad faith” — where the director is “motivated by an actual intent to do harm” — will also qualify as conduct that deprives the director of the benefits of the exculpation provision, according to *Disney*.

CHAPTER 7

THE DUTY OF LOYALTY

ChapterScope

This Chapter covers the duty of "loyalty" owed to the corporation by its directors, officers and controlling shareholders (which we call "Key Players.") Key concepts:

- **Self-dealing transactions:** In a transaction where the Key Player and the corporation are on ***opposite sides*** (e.g., the Key Player sells property to the corporation), the transaction may be voided by the court, and the Key Player required to pay damages to the corporation, unless the conflict is disclosed in advance.
  - **Approval by disinterested holders or directors:** The best way for the Key Player to avoid self-dealing problems is for her to: (1) ***disclose*** the conflict and the nature of the transaction ***in advance***; and (2) have a majority of the ***disinterested directors*** or ***disinterested shareholders pre-approve*** the transaction after this disclosure.
  - **Fairness or ratification:** Alternatively, the Key Player will avoid self-dealing problems if either: (1) the transaction is basically ***"fair"*** to the corporation; or (2) disinterested directors or shareholders ***ratify*** the transaction after the fact, after receiving full disclosure about it.
- **Executive compensation:** Decisions about a senior executive's ***salary***, bonuses, stock options or pensions may be overturned if they are ***clearly "excessive,"*** taking into account the nature of the executive's services.
- **Corporate opportunity doctrine:** Before a director or senior executive may take for himself an ***opportunity*** that is likely to be of interest to the corporation (e.g., purchase of some property adjacent to the corporation's property), he must first ***offer that opportunity*** to the corporation. If he doesn't, he may be required to surrender the opportunity to the corporation after the fact, and/or pay damages.

- **Sale of control:** The owner of a controlling block of stock is generally allowed to sell his shares for an above-market ***"premium," without sharing*** that premium with other shareholders. However, there are several exceptions.

I. FIDUCIARY STATUS OF DIRECTORS, OFFICERS AND CONTROLLING SHAREHOLDERS

A. Key Players as trustees: It is sometimes said that directors, officers and controlling shareholders are in effect ***"trustees"*** of the corporation, and have a ***fiduciary obligation*** to it. As Justice Cardozo said (in a case involving a joint venture rather than a corporation, but a case which is often cited in connection with the duties of corporate directors and officers): "Joint adventurers … owe to one another … the ***duty of the finest loyalty***. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place." *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

1. Partial truth: However, the statement that officers, directors and controlling shareholders are in effect trustees of the corporation is only ***partly accurate***. It is true that these Key Players have varying duties to the corporation and its other shareholders that are somewhat similar to the fiduciary duties that a trustee incurs. But there are important differences. For example, a trustee must behave in a prudent manner, whereas the managers of a business enterprise are expected to take risks, sometimes big ones (and often ones that would be inappropriate for a trustee). Similarly, a controlling shareholder may have certain duties to the corporation and to the minority shareholders, but he nonetheless owns his shares, and within fairly broad limits is entitled to sell them when and how he wishes, without concern for the minority; again, this is quite different from the position of the trustee, who must put the interests of the beneficiary ahead of his own interests.

2. **Full-time employee:** There is one situation in which fiduciary responsibilities will be quite strictly enforced in corporate law: any full-time ***employee*** of the corporation (including an ***officer***) is an ***agent*** of the corporation, and is subject to all the fiduciary rules of agency, including a very strict ban on self-dealing.

   a. **Directors and controlling stockholders:** By contrast, an outside director, and a controlling shareholder who is not employed by the corporation, are usually held to at least a somewhat more lenient fiduciary standard. This difference is especially noticeable in the corporate opportunity context (*infra*, p. 219) — a business opportunity that a full-time employee learns about is much more likely to be found to "belong" to the corporation, than is a business opportunity that an outside director or non-employee major shareholder learns about.

II. SELF-DEALING TRANSACTIONS

A. **Kind of transactions we're concerned with:** The first context in which we need to consider the "duty of loyalty" is the context of the ***self-dealing transaction***. The key aspect of such transactions is that the Key Player (officer, director or controlling shareholder) and the corporation are on ***opposite sides*** of the transaction.

1. **Why we're concerned:** More precisely, we're especially concerned with transactions in which ***three conditions*** are met:

   ❏ the Key Player and the corporation are on ***opposite sides***;

   ❏ the Key Player has helped ***influence*** the corporation's decision to enter the transaction; and

   ❏ the Key Player's ***personal financial interests*** are at least potentially ***in conflict*** with the financial interests of the corporation, to such a degree that there is reason to doubt whether the Key Player is necessarily motivated to act in the corporation's best interests.

   See Clark, p. 147. When we use the term "self-dealing

transaction" in this book, we'll be referring to transactions that satisfy all three of these requirements.

a. **Sale of property:** For instance, the paradigmatic illustration of the self-dealing transaction is the ***sale of property*** by a director to the corporation, or by the corporation to the director. If the director has influenced the corporation's decision to make the transaction, there is reason to fear that a sale by the corporation to the director will be at too low a price, and a sale by the director to the corporation will be at too high a price.

2. **If transaction with stockholder:** Observe that the fact that the Key Player happens to be a shareholder in the corporation does not remove this danger of unfairness to the corporation. For even though damage to the corporation will hurt the Key Player *qua* shareholder, the gain to him in his role as independent person will probably be greater than the loss to him as shareholder. This is true even if he is the majority shareholder.

> **Example:** Smith owns 70% of the stock of XYZ Corp. He is also president and one of the three directors. XYZ Corp is in the business of building hotels on property that it acquires. Smith happens to own Blackacre, a nice two acre parcel that he and his fellow directors agree is perfect for XYZ to build a hotel on. The board approves XYZ's purchase of the property from Smith at a price of $1 million.
>
> There is reason to worry that this price is too high and is therefore unfair to the corporation. True, if the price is $100,000 too high, Smith will bear $70,000 of this loss (because he owns 70% of the stock). But on the other hand, Smith ends up with $100,000 extra in his pocket, so he is ahead by a net amount of $30,000, and the minority shareholders are behind by $30,000. Since there is reason to think that Smith may have influenced the board's decision even if Smith himself didn't vote on the transaction (the other two directors know that they effectively serve at Smith's pleasure, and that he can decline to reelect them

next time), we have all three ingredients for a self-dealing transaction that should be closely scrutinized: (1) a Key Player in a transaction with the corporation; (2) the Key Player possibly influencing the corporation's decision to enter the transaction; and (3) the Key Player's personal financial interests in conflict with those of the corporation (Smith wants to sell high, the corporation wants to buy low). Therefore, a court will probably scrutinize the transaction fairly closely, and will void it if it appears unfair to the corporation.

B. Historical rule: Courts have gradually become somewhat more tolerant of self-dealing transactions.

1. **Initial rule:** Until the late 1800s, courts were completely uncompromising: self-dealing transactions were ***completely prohibited***. For example, it didn't matter that the transaction was "fair" when viewed by an impartial observer, or that the transaction purported to have been approved by a majority of disinterested directors with full knowledge of the facts.

2. **Fair and ratified transactions:** By 1910, most courts had eased that prohibition somewhat: a self-dealing transaction would be allowed to stand if it was ***both*** approved by a majority of fully-informed disinterested directors, and was "fair" to the corporation (as determined by the court). But a contract in which a ***majority*** of the board was interested was voidable even if fair.

3. **Modern view:** By 1960, the still more liberal view that generally applies today was in place: a self-dealing transaction found by the court to be ***fair*** would be ***upheld***, whether approved by a disinterested board or not. (In most states, the rule is at least partly established by statute.)

   See generally Clark, pp. 160-61.

4. **Rationale:** The cases give no clear explanation for this dramatically increased tolerance for at least those self-dealing transactions that are found to be fair. Probably much of this tolerance comes from recognition that there will generally be an

economic benefit to the corporation from allowing fair but self-dealing transactions — especially in the case of the close corporation (see *supra*, p. 133), transactions between a Key Person and the corporation may be the ***only way*** a corporation can obtain funds, goods or other things it needs.

Example: Suppose that Close Corp. is formed by three shareholders, A, B and C. The corporation needs working capital to pursue its business (a service business which so far has no tangible assets). Banks are unwilling to lend to Close. A and B cause a corporation that they control to make an unsecured loan to Close at the prime rate. The transaction is never approved by the sole disinterested director, C, and it is never formally ratified by the stockholders acting as such.

In the late 1800s or even 1910, a court would have voided the transaction at C's request, without considering its fairness to Close. But a modern court would probably determine that it was fair to the corporation (since it was not at an excessively high interest rate, and no better terms seemed to be available from other sources), despite the lack of direct approval by disinterested directors or shareholders. The reason is that the transaction has been beneficial to Close, since it enabled it to get funds that it could not otherwise easily obtain.

C. Modern rule in detail: Let us now consider in more detail the modern rule. You must keep in mind that there is substantial variation among states, and that we are merely trying to summarize the view of ***most*** courts.

1. Statement of rule: Most courts, acting by a combination of statutory interpretation and common-law principles where the statute is silent, seem to divide self-dealing transactions into three categories:

a. Fair transactions: If the transaction is found to be ***fair*** to the corporation, considering all the circumstances, nearly all courts will ***uphold*** it. This is true ***whether or not the***

transaction was ever approved by disinterested directors or ratified by the share-holders.

b. Waste/fraud: If the transaction is so one-sided that it amounts to ***"waste"*** or ***"fraud"*** against the corporation, the court will usually ***void it*** if a stockholder complains. This is true even though the transaction has been approved by a majority of disinterested directors (acting with full knowledge of the transaction they were approving) or ratified by the shareholders.

c. Middle ground: If the transaction does not fall into either of these categories — the court is not convinced it's perfectly fair, but the unfairness does not amount to waste or fraud — the court's response will probably depend on whether there has been ***director approval*** and/or ***shareholder ratification***. If a majority of disinterested and knowledgeable directors have approved the transaction, the court will probably uphold it; the court will similarly uphold it if it has been ratified by the shareholders. If neither disinterested director approval nor shareholder ratification has occurred, the court will probably invalidate the transaction. The ***burden of proof*** is on the ***Key Player***; he must show that the transaction was approved by either: (1) a disinterested and knowledgeable majority of the board ***without participation by the Key Player***; or (2) a majority of the shareholders ***after full disclosure*** of the relevant facts.

2. Summary: Thus the most important variable in the modern cases seems to be ***fairness***; clearly-fair transactions are always upheld, clearly-abusive ones (waste or fraud) are always struck down, and only if the transaction's fairness is ambiguous will the fact of disinterested director approval or shareholder ratification make a difference. See generally, Nutshell, p. 321.

3. MBCA: The corporation statutes of 38 states have explicit provisions dealing with transactions between the corporation and a Key Player. Most of these statutes deal solely with contracts between the corporation and a ***director***, not those between a

corporation and a non-director officer or controlling shareholder. Probably the most important, and explicit, such statute is MBCA §§8.60-8.63. These sections were made part of the MBCA in 1988, replacing a much simpler single provision. Although these new sections have so far not been widely adopted by the states, they are likely to become increasingly influential.

a. Typical approach: Also, the general pattern of these MBCA provisions — that a self-dealing transaction will be upheld if it is either approved by disinterested directors, ratified by shareholders or found by a court to have been fair — is typical of the approach of most states. Therefore, we consider the MBCA provisions in some detail. §§8.60-8.63 are usually collectively referred to as "Subchapter F" of the MBCA.

b. Key section: The key section of the MBCA Subchapter F is §8.61:

> **§8.61 Judicial Action**
>
> (a) A transaction effected or proposed to be effected by a corporation (or by an entity controlled by the corporation) may ***not*** be the subject of ***equitable relief*** or give rise to an ***award of damages*** or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an ***interest*** in the transaction if it is ***not a director's conflicting interest transaction***.
>
> (b) A ***director's conflicting interest transaction*** may ***not be the subject of equitable relief,*** or give rise to an ***award of damages*** or other sanctions against a director, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an ***interest respecting the transaction*** if:
>
> (1) ***directors' action*** respecting the transaction was taken in compliance with section 8.62 at any time; or
>
> (2) ***shareholders' action*** respecting the transaction was taken in compliance with section 8.63 at any time; or
>
> (3) the transaction, judged according to the circumstances at the relevant time, is established to have been ***fair to the corporation***.

c. Definitions: Section 8.60 supplies a set of definitions for Subchapter F; these definitions are too long and convoluted to be reproduced here in full. However, we discuss a few of the definitions here.

i. "Director's conflicting interest transactions": The core definition is that of "Director's conflicting interest transaction," defined in §8.60(1) as follows:

> (1) ***"Director's conflicting interest transaction"*** means a transaction effected or proposed to be effected by the corporation (or by an entity controlled by the corporation)
>
> > (i) to which, at the relevant time, ***the director is a party***; *or*
> >
> > (ii) respecting which, at the relevant time, the ***director had knowledge and a material financial interest known to the director***; or
> >
> > (iii) respecting which, at the relevant time, the director ***knew that a related person was a party or had a material financial interest***."

ii. "Related person": Another key definition is ***"related person."*** Under §8.60(5), a "related person" encompasses principally the director's spouse, child, grandchild, sibling or parent (or any of these people's spouses), or any trust or estate as to which the director is a beneficiary or fiduciary. But the concept also includes any ***business or non-profit of which the director in question is a director or partner.***

iii. "Material financial interest": Next, there is a definition of ***"material financial interest"***: this means "a financial interest in a transaction that would reasonably be expected to impair the objectivity of the director's judgment when participating in action on the authorization of the transaction." §8.60(4).

iv. "Required disclosure": Finally, there is a definition of ***"required disclosure,"*** which means "disclosure of (i) the ***existence and nature of the director's conflicting interest***; and (ii) all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would ***reasonably believe to be material in deciding whether or not to proceed with the transaction."*** §8.60(6).

v. Explanation: Integrating these definitions: no matter whether the transaction involving the corporation is major or minor, it's automatically a "director's conflicting interest transaction" if *either* of the two following things is true:

[1] the director in question, or her ***close relative*** (or a business entity or non-profit that either the director or her close relative controls or ***serves as a director***) ***is a party*** to the transaction; or

[2] the director or her close relative (or a business entity or non-profit that either the director or her close relative controls or serves as a director) has (and knows she has) a ***"material financial interest"*** concerning the transaction.

Example of [1] (D is a party): A director (call him "D") of X Corp. uses his influence to cause the board of X Corp to authorize the purchase of $1,000 worth of office supplies from Z Corp., of which D is also a director. D is a multimillionaire, and does not benefit (or think he will benefit) in any way from the sale of supplies. Because D is a director of Z Corp., Z Corp. is a "related person" to D. D does not disclose to X's board that D is a director of Z Corp.

Since a related person to D is a direct party to the transaction with X Corp., the sale of supplies is a "director's conflicting interest transaction" as to D. Therefore (as we'll see in the next section entitled "three-part approach"), under the MBCA the court may enjoin it, or award damages against D in connection with it, if it's not approved by the Board or the shareholders of X Corp. after proper disclosure by D of his interest, and is "unfair" to X. So, for instance, if X is overcharged by $400, under the MBCA X can be required to pay the $400 back to X Corp. in damages, even though the small size and D's wealth meant that he did not have a "material financial interest" in the transaction. In other words, the fact that a "related person" to D (i.e., Z Corp.) was a party *automatically* made the transaction a "director's conflicting interest transaction" as to D.

Example of [2] (D has a "material financial interest" but is not a party): D (again a director of X Corp.) suggests to X Corp's board that X Corp. should purchase, for $1 million, a parcel of vacant land from Sell, an individual. Sell is not a "related person" to D. However, unbeknownst to any other board member or executive of X Corp., not only are D and Sell good friends, but prior

to the transaction Sell has promised D that if Sell is able to sell the property for $1 MM to X Corp., then Sell will pay a $50,000 "commission" to D.

This quid pro quo has almost certainly given D a "material financial interest" concerning the purchase of the parcel from Sell (since the prospect of receiving a $50,000 fee "would reasonably be expected to impair the objectivity of the director's judgment when participating in action on the authorization of the transaction," the standard for whether the director has a "material financial interest.") If so, then under the MBCA a sale authorized by X Corp's board is a "director's conflicting interest transaction" as to D. Consequently, if D does not disclose the conflict and then get the transaction approved either by the Board or the shareholders of X Corp., then unless the transaction is "fair" to X Corp., a court acting under the MBCA could either enjoin it or award damages against D. And that's true even though D is not directly a party to the transaction — D's having a "material financial interest" is a substitute for D's being a party to the transaction. (The same would be true if, say, it was a *sibling or child* of D who would get the commission — if a "related party" to the director has a material financial interest in the transaction, it's the same as if the director himself had such an interest.)

d. Three-part approach: The guts of Subchapter F are set forth in §8.61 (reproduced above). That section imposes two major rules:

i. Non-conflict transactions: Where a transaction is "***not*** a director's conflicting interest transaction" (under the definitions summarized in (c) above), the court may ***not*** enjoin it or set it aside on account of any interest which the director may have in the transaction.

ii. Conflict transactions: If the transaction ***is*** a "director's conflicting interest transaction," the corporation and the director receive a ***"safe harbor"*** for the transaction — and

the court may thus not set it aside — if: (1) a ***majority of disinterested directors approved it*** after disclosure of the conflict to them (§8.62); or (2) a majority of the votes held by ***disinterested shareholders*** are cast in a vote ***ratifying*** the action, after disclosure of the conflict (§8.63); or (3) the transaction, "judged according to the circumstances at the time of commitment, is established to have been ***fair*** to the corporation."

e. Commentary: Here are several aspects of Subchapter F that may not be obvious:

i. Exclusive definition of "conflicting interest": First, the definition of "director's conflicting interest transaction" given in §8.60 is ***exclusive***. That is, if the transaction does ***not*** fall within the definition given there, the transaction is automatically deemed ***non-conflicting***, and the court may not overturn it on grounds of director self-interest.

Example: D is a director of X Co. X Co. proposes to enter into a transaction with Smith, who is D's cousin. The transaction comes before the X Co. board for approval. D and Smith are not only cousins but extremely close friends, and D knows that Smith desperately needs the money which would come to him as the result of the proposed transaction. D does not disclose to the X Co. board the fact that Smith is his cousin, or that D wishes the transaction to go forward so as to aid Smith. D has no independent financial interest in the transaction. The board members listen to D's urging that the transaction be approved, and vote for approval. P, a shareholder, now sues the board and Smith, seeking to have the transaction set aside.

Under the MBCA approach, the court must conclude that there is *no conflict*, and may therefore not even consider overturning the transaction on conflict grounds. The reason is that a cousin is not "related person" under the definitions given in §8.60(5), and D had no direct financial interest of his own in the transaction. Since the transaction is not a "director's conflicting interest transaction" as defined in

§8.60(1), §8.61(a) requires that the court not enjoin it on account of any conflict arising out of the X-Smith relationship. (This example is suggested by an example given in Official Comment 1 to §8.61.)

ii. Directors only: Second, Subchapter F covers only transactions between the corporation and one of its ***directors***. Transactions between the corporation and a non-director ***officer or shareholder*** are not covered by Subchapter F (and are in fact not covered by ***any*** provision of the MBCA having to do with self-dealing). Thus transactions with non-director officers or shareholders under the MBCA are left entirely to ***common-law principles*** (though the court is likely to approach these in almost the same way as a transaction between the corporation and a director).

iii. Disclosure after controversy: Third, the disclosure and approval can happen even ***after the transaction has been challenged*** by a dissident shareholder or third party. In other words, after-the-deal ***ratification*** by the board can suffice — pre-approval is not necessary. See Official Comment to MBCA §8.62(a).

Example: A majority of disinterested directors approve Corp's purchase of land from Landco, a limited partnership. At the time of the approval vote, the directors don't know that Bob, one of the directors, is secretly a major partner in Landco. The purchase goes through. Steve, a minority holder in Corp., then learns of the conflict. He brings a derivative suit to have the transaction unwound. If nothing further happens (and if the court finds that the transaction was "unfair" to Corp.), the court will probably order the transaction unwound or at least order that Bob pay damages to Corp. But if, within a reasonable time after Steve brings suit, the board ratifies the transaction with full disclosure of the nature of the transaction and nature of Bob's ownership interest in the selling partnership, the court will not interfere.

4. **Three paths:** Under the MBCA and the statutes of most states, there are thus three different ways that proponents of a self-dealing transaction can avoid invalidation:

[1] by showing that it was ***approved by a majority of disinterested directors***, after full disclosure;

[2] by showing that it was ***ratified by shareholders***, after full disclosure; and

[3] by showing that it was ***fair when made***.

Let's now consider each of these branches in detail in Paragraphs D, E and F below.

D. Disclosure plus board approval: The general principle behind the "board approval" branch is simple to state: a ***transaction may not be avoided by the corporation if it was authorized by a majority of the disinterested directors, after full disclosure of the nature of the conflict and the transaction***. However, this formulation raises a number of questions:

1. **What must be disclosed:** ***What information*** is it that must be disclosed to the disinterested directors? Most courts (and the MBCA) require disclosure of ***two*** major kinds of information: (1) the material facts about the ***conflict***; and (2) the material facts about the ***transaction***.

a. **Conflict:** Often the fact that there is a conflict will be obvious to the disinterested directors (e.g., when the contract runs directly between the director and the corporation). But other conflicts will not be obvious, and must therefore be disclosed by the Key Person. This will be true, for instance, if the other party to the transaction is a ***corporation*** in which the Key Person has a significant pecuniary interest. (See the discussion of indirect conflicts, *infra*, p. 209.)

Example: XYZ Corp wants to buy an office building. D, a vice president of XYZ, owns all of the stock of Realty Corp, which owns an office building. D has a real estate broker offer the building to XYZ, and the board of XYZ votes to acquire it. The other directors are not aware that D has an

interest in Realty Corp.

Even though all material economic facts about the underlying transaction (e.g., the condition and market value of the building) have been disclosed to the other board members, approval by the board of the contract will not insulate the transaction from attack, because D has not disclosed his financial interest in Realty Corp to the board. See MBCA §8.62 (requiring disclosure to the board, before approval, of details regarding the director's conflict); §8.60(6) (defining the required disclosure).

b. Disclosure of transaction: Apart from disclosure of the facts that cause a conflict, the Key Person must also disclose all facts about the ***underlying transaction*** that a reasonable observer would consider ***"material."*** This obligation goes far beyond the ordinary duty of one party to a contract to disclose essential facts to the other. For instance, if the Key Person knows of facts that are likely to make the proposed contract turn out to the disadvantage of the corporation, ***he must disclose those facts***, whereas a third party negotiating at arm's length with the corporation could remain silent.

c. When disclosure must be made: You might think that the requirement of disclosure means that the disclosure must take place ***before*** the transaction is entered into. But courts are in fact in disagreement about whether this is required.

i. Ratification allowed: Some courts will uphold the transaction based on board approval even if the disclosure does not come ***until*** after the transaction is entered into, so long as the directors then ***"ratify"*** it (by formally stating that they have no objection, or perhaps even by simply failing to raise an objection). Thus MBCA §8.61(b)(1) insulates the transaction against judicial review if "directors' action respecting the transaction was ***at any time*** taken in compliance with §8.62" (providing for approval by disinterested directors). The phrase "at any time" is intended to allow for post-transaction ratification.

ii. **Contrary view:** But other courts require the disclosure to occur before the transaction, or at least make it tougher for transactions to be ratified after the fact instead of approved beforehand.

2. **Who is a "disinterested" director:** The approval must be by a majority of the ***"disinterested"*** directors. Who is "disinterested" for this purpose? Most courts would probably agree with the MBCA, which says that a director is "qualified" (the MBCA's term for "disinterested") if (i) the transaction is not a "director's conflicting interest transaction" (see *supra*, p. 201 for what this means); *and* (ii) the director does not have a "material relationship" with another director as to whom the transaction is a "director's conflicting interest transaction." MBCA §1.43(a)(3).

 Example 1: The proposed transaction is between X Corp. and Z Corp., under which X Corp. will buy a piece of real estate from Z Corp. The issue is whether D, a director of X Corp., is "disinterested" (or under the MBCA, "qualified"), so that D's vote to approve the transaction can contribute to the required approval by a majority of disinterested directors. Assume that D is also a director of Z Corp. D is not qualified, because under the combination of MBCA §§8.60(1)(iii) and 8.60(5)(v), D's being a director of Z Corp. makes Z Corp. a related person to D, and the fact that D has a related person who has a "material financial interest" in a transaction makes the transaction a "director's conflicting interest transaction" as to D.

 Example 2: Same basic facts as above example. Now, however, D has no direct relationship with Z Corp. However, D's boss, B, who also happens to be on X Corp's board, is a director of Z Corp. Since D has a material relationship with B (boss-subordinate would almost certainly be a material relationship), the fact that the transaction is a director's conflicting interest transaction as to B means that D, too (not just B) is not a disinterested or qualified director.

a. **Outside professionals:** Even outside directors who serve as ***professionals*** (e.g., outside counsel or outside accountant) to the corporation may be found to be "interested" in a transaction in which the CEO is a party. The theory for treating these professionals as "interested" is that they may be afraid they will no longer be engaged by the corporation if they annoy the CEO by voting against the transaction. Thus on the facts of Example 2 above, if D was not B's subordinate, but was instead a lawyer who relied on B for lots of business, D would likely not be disinterested.

3. **Quorum:** Often, especially in the case of a close corporation, a majority of the directors will be "interested" in the transaction. (For instance, the CEO may be a party to the transaction, and a majority of the directors may be full-time employees who owe their jobs to him.) In this situation, there will of course not be enough disinterested directors to constitute a quorum of the board. Therefore, a special rule exists in almost all states to facilitate approval by the disinterested directors: if a ***majority of the disinterested directors*** approve the transaction, this constitutes not only approval, but also a ***quorum***. (However, most statutes require ***at least two*** disinterested directors to approve the transaction.) See MBCA §8.62(c), and Del. GCL 144(a)(1), both to this effect.

Example: The board of XYZ Corp has five directors. Two of them propose to enter into a contract with XYZ, and are therefore interested directors. The other three are not interested. One of the three disinterested directors is absent from the board meeting. The other two disinterested directors are sufficient to constitute a quorum for approval purposes (since they represent a majority of the three disinterested directors). If these two approve the transaction, this will constitute the requisite disinterested-director approval.

If, on the other hand, two of the three disinterested directors were absent, the third director's vote approving the transaction would not constitute either a quorum or

approval, because there would not be approval by a majority of the total disinterested directors (those present and those absent).

4. **Presence or vote of interested director:** Ideally, the ***interested*** director should ***abstain*** from either voting or even lobbying the disinterested directors concerning the transaction. However, most statutes provide that participation by the interested director in the consideration or voting does ***not*** by itself nullify the approval by the disinterested directors — the interested director's presence and/or vote is simply ***disregarded***, and the sole question is whether a majority of the total disinterested directors has approved the transaction.

   a. **Different rule in MBCA:** But some statutes say that ***no interested director(s) may be either present or voting*** (presumably for fear that the interested director's mere presence may sway the others.) See, e.g., MBCA §8.62(a)(1), which says that a vote by the disinterested directors authorizing the transaction will be effective only if the disinterested directors "have deliberated and ***voted outside the presence of and without the participation by*** any other [i.e., interested] director."

5. **Committee:** Under most statutes, approval by disinterested directors may be done at the level of a ***committee*** rather than the full board. Usually, this committee may be either one that already exists (e.g., the compensation committee), or one appointed specially to consider the particular transaction. In any event, all that is required for a quorum and for approval is the approval by a majority of the disinterested directors ***on the committee***, even if this is less than a majority of the total disinterested directors on the board.

6. **Immunization of unfairness:** Suppose a majority of disinterested directors (acting after full disclosure of all material facts) approves a transaction that, viewed later by a court, is clearly ***unfair*** to the corporation. Does the disinterested-director approval completely immunize the transaction against attack for

self-dealing? Most statutes are written as if the answer were ***"yes."*** However, in practice courts often void such transactions if the unfairness is great, despite the disinterested-director approval; frequently, they accomplish this result by finding that the transaction constituted "waste." (The effect of unfairness is discussed more extensively, *infra*, p. 208.)

a. **Shifting of burden of proof:** In most states, approval by the disinterested directors does seem to at least ***shift the burden of proof***: if the transaction has not been approved by disinterested directors (or shareholders), the burden is generally on the Key Player to prove that it was fair; once approved by disinterested directors, the burden shifts to the person attacking the transaction to show that it was unfair. See *infra*, p. 209.

E. **Disclosure plus shareholder ratification:** The second main branch for validating a self-dealing transaction is the ***ratification by shareholders***, following disclosure to them.

1. **Disclosure required:** As in the case of disinterested-director approval, the shareholder ratification will be effective only if it comes after there has been ***full disclosure*** to the shareholders of ***both the conflict*** and the ***material facts of the transaction itself***.

2. **Disinterested shareholders:** Recall that in the case of director authorization, a majority of the ***disinterested*** directors must approve. Does a comparable rule apply to shareholder ratification, or may interested shareholders vote and be counted towards a majority? The courts are hopelessly ***split*** and confused about this issue — some seem to say that shareholder ratification has no effect unless a majority of the disinterested shareholders approve, whereas others seem to hold that all shareholders may vote and be counted. A court is likely to give a more searching inquiry into the transaction's underlying ***fairness*** (*infra*, p. 208) in those situations where it is not clear that a majority of the disinterested shareholders has approved.

a. **MBCA:** The MBCA takes a stringent view: under §8.63(a), a majority of the ***disinterested*** shareholders must approve the

transaction. (On the other hand, for purposes of determining whether the transaction is approved under general corporate action principles having nothing to do with the conflict, interested shareholder votes may be counted, and are part of the quorum.)

Example: Assume that Parent Corp owns 60% of Subsidiary Corp. Parent Corp wants to merge Subsidiary Corp into itself. Because Parent Corp is a party to the transaction, the conflict will be deemed ratified by the shareholders only if at least half of the holders of the minority block approve it, under MBCA §8.63(a) and (c). See Official Comment 3 to MBCA §8.63. However, for purposes of determining whether the general requirement of shareholder approval for *any* merger under the MBCA has occurred, and for determining whether there has been a quorum for that approval, Parent Corp's votes may be counted.

F. Fairness as the key criterion: The final method of defending a self-dealing transaction against attack is by showing that it is, under all the circumstances, ***fair*** to the corporation.

1. Fairness alone sufficient: In nearly all states, ***fairness alone*** will cause the transaction to be ***upheld***, even if there has been ***no approval*** by disinterested directors and no ratification by shareholders.

a. Measured at time of transaction: "Fairness" is generally determined by the facts as they were ***known at the time of the transaction***. See, e.g., MBCA §8.61(b)(3) ("judged according to the circumstances at the relevant time[.]")

2. No requirement of prior disclosure: In most courts, the transaction will withstand attack if it is proven fair, even though ***no disclosure whatsoever*** is made by the Key Player to his fellow executives, directors or shareholders. Thus in the office building example on p. 205 *supra*, even if D never disclosed to anyone that he was a controlling shareholder in the firm that owned the building being sold to the corporation, most courts

would hold that so long as the pricing terms were in line with what would have been produced by arm's length bargaining, the transaction may not be avoided by the corporation.

3. **Authorization/ratification does not immunize from unfairness:** In most states, fairness is really the ***key element***. As we've just seen, if the transaction is fair, lack of disinterested-director authorization or shareholder ratification will not make a difference. Conversely, if the transaction is found by the court to be grossly ***unfair***, under most statutes the fact that there *was* approval by disinterested directors, or ratification by shareholders, will ***not immunize*** the transaction.

   a. **Delaware allows immunization:** But some jurisdictions, probably a minority, do allow disinterested-director authorization or shareholder ratification to ***immunize*** even an unfair transaction from judicial review. Delaware, for instance, seems to allow such immunization. As the Delaware Supreme Court has stated: "Approval by fully-informed disinterested directors under §144(a)(1), or disinterested stockholders under §144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste, with the burden of proof upon the party attacking the transaction." *Marciano v. Nakash*, 535 A.2d 400 (Del. 1987).

   b. **MBCA allows immunization:** Similarly, the MBCA forbids judicial review of the fairness of director-authorized or shareholder-ratified transactions. §8.61(b) (as noted *supra*, p. 201) states that the court may not overturn a director-conflict transaction if the action was authorized by disinterested directors after disclosure, or ratified by disinterested shareholders after disclosure.

4. **Significance of director or shareholder approval:** If fairness is what really counts — that is, if fair transactions will be upheld even without director or shareholder approval, and unfair ones will be struck down even with shareholder or director approval — why bother to get approval by disinterested directors or by

shareholders? The answer is that in most states, there is still some practical benefit to this kind of approval, a benefit which stems from ***standards of proof*** and the ***burden of proof***.

a. **Standards of proof:** First, in most states, the ***degree of unfairness*** that must be shown to upset a transaction that has been approved by disinterested directors or shareholders is probably ***greater*** than where there has been no approval. Some courts accomplish this by saying that a director-approved or a shareholder-approved transaction will only be overturned if the unfairness is so great that it amounts to ***fraud*** or ***waste***. Others appear to look for "gross" unfairness, as opposed to the "ordinary" unfairness that will be enough for invalidation where there has been no approval.

b. **Burden of proof:** Second, the ***burden of proof shifts*** in most states when there has been director or shareholder approval. Without such approval, the burden of proof is clearly on the ***Key Player*** to show why the transaction is fair. Once there has been disinterested-director approval or shareholder approval, the burden shifts to the person who is attacking the transaction, who must now come forward with evidence of the transaction's ***un***fairness. Most statutes do not expressly document this shift in the burden of proof, but courts seem to make the shift anyway.

G. **Indirect conflicts involving Key Player:** So far, we've generally assumed that the Key Player is himself directly a party to the transaction in question. But the rules against self-dealing also apply where the conflict of interest is ***"indirect."*** That is, self-dealing problems arise where the Key Player has an interest or association with ***some other entity***, and it is that entity that enters into the transaction with the corporation.

1. **Pecuniary interest:** In general, if a Key Player's ***financial interest*** in the other entity is such that this interest would reasonably be expected to ***affect his judgment*** concerning the transaction, the self-dealing rules apply. For instance, if the Key Player is a significant ***stockholder*** of the other corporation, or a

partner in a partnership, the transaction involving that other corporation or partnership will be deemed self-dealing, and the rules described above will apply. The office building hypothetical on p. 205 is an example of this principle.

2. **Interlocking directors and other non-ownership problems:** Suppose the Key Player does not have a significant ownership interest in the other entity, but is a full time ***executive*** or a ***director*** of that other entity. Here, the self-dealing problem is usually thought to be less severe, so the full range of self-dealing rules does ***not*** apply. For instance, the fact that a person serves on the board of directors of both companies (the ***"interlocking directorate"*** problem) will not by itself usually cause a transaction between the two companies to constitute self-dealing by the director.

   a. **MBCA is different:** But again, in this interlocking-directorate scenario the MBCA is ***much stricter*** than the usual state statute. One of the ways a transaction will be a "director's conflicting interest transaction" is if the director "knew that a related person was a party or had a material financial interest" in the transaction. MBCA §8.60(1)(iii). "Related person" is defined in §8.60(5)(v) to include "a domestic or foreign … business … of which the director is a director." So a person who is a director of both corporations is not, under the MBCA, a disinterested (or "qualified," to use the MBCA's term) director as to any transaction between the two corporations.

      Example: D is a director of A Corp and B Corp. A Corp. proposes to buy a piece of real estate from B Corp. When A Corp's board votes on the transaction, D will not be a "qualified" (i.e., disinterested) director, because he is a director of a related person (related to him, that is) — B Corp — and that related person is a party to the proposed transaction. Therefore, D must be careful to make disclosure of his conflict, and then not participate (or be present at) the vote by A Corp's board.

H. Remedies for violation: Where there has been a violation of the rule against self-dealing, there are two possible ***remedies***: (1) ***rescission***; and (2) ***restitution*** in the form of money damages. The plaintiff will normally be the ***corporation itself***, or a shareholder who has brought a derivative suit (*infra*, p. 318) in the corporation's name.

1. **Rescission:** If it is possible to ***rescind*** the transaction, this is normally the appropriate remedy for self-dealing. For instance, in the office building sale hypothetical (*supra*, p. 205), if suit were brought by the corporation or a shareholder in a derivative suit, and the closing had not yet occurred, the court would simply order that the contract be cancelled. If there is to be rescission, the corporation must ***give back*** any consideration it has received in the transaction. For instance, if the corporation has sold corporate property to a Key Player in what turns out to be an unfair transaction, the corporation may obtain return of the property, but it must then return to the Key Player the price he paid.

2. **Restitutionary damages:** If because of the passage of time or the complexity of the transaction, it is not feasible to rescind it, the appropriate remedy is ***restitutionary damages***. That is, the Key Player will be required to pay back to the corporation any benefit he received beyond what was fair. For instance, in our office building sale hypothetical (*supra*, p. 205), if Realty Corp received $1 million for the sale of the building, and the fair market price was only $800,000, D or Realty Corp would have to return to XYZ the $200,000 excess over fair value.

3. **Consequence:** Observe that neither rescission nor restitution is a very strong deterrent to self-dealing: In either case, the Key Player who has engaged in the wrongful self-dealing is merely ***returned to the same position*** he would have been in had he not done the transaction at all. See C&E, pp. 662-63. However, some courts have ordered the self-dealing Key Player to also return any ***salary*** he earned during the relevant period, have awarded ***punitive*** damages to the corporation, or have ordered the self-dealer to pay the corporation's ***counsel fees*** and other litigation

expenses. C&E, pp. 663-64.

Quiz Yourself on
THE DUTY OF LOYALTY *(SELF-DEALING TRANSACTIONS)*

47. Mr. Haney is one of six directors of the Green Acres Produce Company. Green Acres is interested in expanding its acreage. It wants to buy a 100-acre tract of land in Hooterville, which is owned by the Hooterville Limited Partnership. When the chairman of Green Acres Produce, Oliver Wendell Douglas, inquires as to a selling price, Hooterville's general partner, Mr. Ziffel, tells him it's $10,000 an acre. Mr. Haney doesn't go to the directors' meeting where the land purchase is discussed; the other five directors approve it unanimously. Unbeknownst to the other board members, Mr. Haney is one of the limited partners in the Hooterville Limited Partnership (he owns a 25% economic interest in the partnership). A minority shareholder of Green Acres finds out about the proposed purchase, and sues to prevent its consummation, on account of the fact that Mr. Haney is arguably on both sides of the transaction. Assume that the proposed price is 30% above market prices for the type of property in question, and that the Hooterville directors who voted in favor of the transaction knew this. Does the fact that the disinterested directors approved the transaction mean that the court should allow the transaction to go forward? ___________________________

48. The Addams Shroud Company provides funeral supplies. It has seven directors — Gomez, Morticia, Puggsley, Wednesday, Fester, Lurch, and Cousin Itt. Of the seven, four of them — Gomez, Morticia, Wednesday, and Puggsley — are also major shareholders of the Arsenic and Old Lace Fabric Company, which makes, among other things, black fabric. The Addams Shroud Company uses a lot of black fabric that it buys from various suppliers. Gomez negotiates a requirements contract on Addams Shroud's behalf with Arsenic and Old Lace. When it comes time for the Addams's board to approve the contract, the four "interested" directors abstain (after making sure that the others know the full details of the conflict and of the contract). The three remaining directors vote, 2-1, to approve the contract. The dissenter argues that the contract has not been properly approved, because a quorum of the board did not participate in

the decision. Has the Addams's board properly approved the contract, in a manner that will immunize the contract from attack on conflict grounds? ____________________________

49. The Enterprise Tribble Company makes funny toys called, predictably enough, tribbles. James Kirk is one of the five directors of Enterprise. He is also majority shareholder of Romulan Card Stores, a chain of greeting card and novelty toy stores. Kirk believes that Romulan can sell Enterprise's entire tribble output. Romulan and Enterprise negotiate a contract, whereby Romulan agrees to pay $5 per tribble (a fair price based on what the parties know at the time), for two years, for 1,000,000 tribbles per year (which is likely to be most of Enterprise's output). Kirk fully discloses his conflict and the material elements of the contract to the other, disinterested members of the Enterprise board, who unanimously approve the contract. It comes as a surprise to everyone when tribbles feature prominently in a Star Trek episode shortly after the contract goes into effect, such that the demand for tribbles — and the price Romulan can charge for them — skyrockets. A minority shareholder of Enterprise, Scotty, can't take it any longer, and files a derivative lawsuit against Kirk, citing the unfairness of the deal and seeking to void it on grounds of conflict of interest. What result? ____________________________

Answers

47. No, because Mr. Haney didn't disclose his ownership interest in the land to the board. This was a director-conflict situation: Haney was a director of the buyer, and he also had a sufficiently large financial interest (25%, or $250,000) in the subject of the transaction that his impartiality can reasonably be questioned.

When a director has a conflict of interest involving a corporate transaction, there are three ways to avoid the transaction's voidability on conflict grounds: (1) full disclosure and disinterested director approval, (2) full disclosure and shareholder approval, or (3) overall fairness. (In practice, most courts require that the transaction be fair regardless of director or shareholder approval.) But the conflict won't be deemed to have been "disclosed" unless the disinterested directors (or shareholders) knew *both* the nature of the transaction *and* the *nature of the conflict*. See,

e.g., MBCA §8.62(a) (making board approval of a conflict transaction effective only if it comes after "required disclosure") and §8.60(6) (defining "required disclosure" as disclosure of (i) "the existence and nature of the director's conflicting interest" and (ii) "all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether or not to proceed with the transaction.")

Here, the disinterested directors didn't know that Haney was a significant partner of the selling entity, so they didn't know of the "nature of the director's conflicting interest." Therefore, there wasn't true disclosure, and the approval by the disinterested directors will be irrelevant. (It's also irrelevant that Haney didn't vote on the proposed transaction — as long as there was a conflict between Haney's role as director of Green Acres and his role as partner in Hooterville, the conflict rules apply, requiring disclosure.)

In fact, full disclosure would probably require not only that the Green Acres board be told that Haney was a partner in Hooterville, but also that the board be told the approximate size of his interest (e.g., that he owned about 1/4 of the economic interest.)

Observe that if the transaction were "fair" to the corporation, the court would probably approve it even without the prior disclosure; but the facts tell you that the price is quite high, thus making it probably unfair. Also, note that even *after the dissident shareholder filed suit*, under most conflict statutes it would not be too late for Haney to make full disclosure, and procure a truly informed approval by the disinterested directors. (See, e.g., Off. Comm. to MBCA §8.62(a)). Such an after-the-fact vote would suffice to immunize the transaction from a court-issued injunction or an award of damages.

48. Yes. The contract will not be voidable on conflict grounds, because a majority of the disinterested directors have approved it after full disclosure.

A conflict arises when a director or officer has split loyalties. Here, the conflict is indirect — four Addams directors are shareholders of a corporation with which Addams Shroud is contracting. The prevailing rule is that such a contract is voidable at Addams's option unless either

disinterested directors approve it on full disclosure, shareholders approve it on full disclosure, or it's fair. Most states hold that as long as a majority of the disinterested directors (with a 2-person minimum) approve the transaction, this counts not only as approval, but also as a quorum. See, e.g., MBCA §8.62(c). Since a majority of the 3 disinterested directors have approved, this condition is satisfied. [206]

49. **The deal isn't voidable, because it was approved by disinterested directors, and, besides, it's fair.** The transaction here involves a conflict because Kirk is a director for one party to a contract and majority shareholder of the other. The general rule is that such a contract is voidable unless either: (1) the transaction and conflict are disclosed to directors, who approve it; (2) the transaction and conflict are disclosed to shareholders, who approve it; or (3) it's fair to the corporation. [200] Here, Kirk fully disclosed the material facts of the deal and the conflict to the disinterested directors of Enterprise, who approved it. This satisfies test (1), and is thus in and of itself enough to avoid voidability on grounds of conflict.

    In any event, the transaction here was "fair" to Enterprise. A court will generally judge fairness as of the time the transaction was made. (See, e.g., MBCA §8.61(b)(3)). [208] At the time this deal was made, everything suggested that the deal was fair to Enterprise. So the transaction satisfies (3), and would therefore not be voidable at Scotty's urging even if full disclosure and pre-approval by the board *hadn't* occurred.

III. EXECUTIVE COMPENSATION

A. **Aspect of self-dealing:** We turn now to what might be thought of as a "special case" or aspect of self-dealing, ***executive compensation***. When an executive is sufficiently senior that he can influence the corporation's decision on his compensation, we have a transaction that presents all the traditional dangers of self-dealing: since the executive is to some extent on both sides of the transaction, there is a risk that the corporation will not be treated

fairly (because it will pay the executive more money than it ought to, and this will be money that belongs to the shareholders). As we will see below, the courts handle the question of executive compensation in much the same way they handle the more general self-dealing problems we reviewed above: they look essentially to the "fairness" of the transaction, and are influenced by the fact that there has been (or has not been) approval by disinterested directors and/or ratification by shareholders.

B. Forms of compensation: Before we get into the tests by which courts evaluate executive compensation, let us first review briefly the common forms that such compensation may take. Executive compensation arrangements may be grouped into three broad categories: (1) ***current*** payments (salary and annual bonus); (2) stock-based ***incentive*** arrangements (stock options, restricted stock, phantom stock and stock appreciation rights); and (3) pensions and other ***deferred cash*** compensation. We consider each of these groups briefly in turn.

1. **Salary and current bonus:** Executives almost always receive two types of ***"current"*** cash compensation: a salary that is paid throughout the year, and an annual cash bonus, typically paid at the end of the year. The bonus is usually geared in some way to the corporation's profits. Both the salary and bonus, if they are reasonable in amount, are ***deductible*** by the corporation when paid, in computing the corporation's taxable income.

2. **Stock-based incentive plans:** Especially in public companies, the corporation (and the outside directors who typically form the compensation committee) worry that senior executives who receive only a salary and an annual bonus will take a short-term view in managing the corporation. To get executives to think more like an "owner," i.e., a shareholder, most publicly held corporations therefore give their executives one or more types of ***long-term incentive*** tied in some way to the performance of the company's ***stock***.

   a. **Stock options:** The most common form of stock-based long-term incentive plan is the ***stock option***. A stock option is the

right to buy shares of the company stock at some time in the future, for a price that is typically set today. If the stock price increases (presumably due in part to the executive's good performance) to where the stock is selling for more than the option price, the executive ***"exercises"*** the option by paying the now-bargain price, and then either immediately resells at a profit or holds onto the stock hoping for still more appreciation. If the stock price never rises above the exercise price, the executive never exercises the option, and has therefore not lost anything. There are two sub-types of options which differ sharply in their tax treatment.

i. **Non-qualified stock options:** A ***"non-qualified"*** stock option (i.e., any option that isn't an "incentive stock option" as described below) does not get any special tax treatment under the Internal Revenue Code. The executive does not receive income when the option is awarded to him; however, when he ***exercises*** the option, he receives immediate income equal to the difference between the exercise price and the present market value, of the stock. This can be burdensome if he wishes to hold onto the stock, since he has to pay taxes without having any cash with which to pay them. (On the other hand, the corporation gets a current deduction for the difference between the exercise price and the present market value, since this is in effect "compensation" and is therefore deductible as an ordinary and reasonable business expense.) See C&E, pp. 701; Clark, pp. 202-03, 210-11.

ii. **Incentive stock options:** The other kind of stock option is the so-called ***"incentive stock option."*** For an option to be an incentive stock option, it must meet several requirements set forth in the Internal Revenue Code (e.g., the option price cannot be less than the stock's per-share market value at the time the option is granted; the employee may not own more than 10% of the company's voting stock, etc.). Incentive options get special tax treatment: the executive is not taxed on any gain at the time he exercises

the option, but only when he ***sells the underlying stock***. If the executive holds the stock bought under the option for a number of years, this deferral of gain has significant value. (On the other hand, the corporation never gets a tax deduction for creating the incentive option. Clark, pp. 21011.)

b. Restricted stock: ***"Restricted stock"*** is a somewhat vague term that refers to stock that is awarded to an employee under a variety of limitations. For instance, an executive might be awarded 100,000 restricted shares, with 10,000 shares "vesting" in each of the next ten years, but only if the executive is still employed on that date. If the executive leaves, his unvested shares would be forfeited. Restricted shares are frequently issued free or at a dramatically reduced price. They are especially useful in a closely-held corporation that expects to go public in the future. C&E, pp. 704-05.

c. Stock Appreciation Rights: A ***Stock Appreciation Right*** (or "SAR") is the right to be paid a future cash bonus based on any ***increase*** in the price of the company's stock. For instance, suppose the company's stock sells for $10 a share on the date the SAR is granted; if the SAR is exercisable after two years, and the stock then sells for $15 a share, the executive would receive a cash payment of $5 ($15 minus $10) for each SAR. Clark, p. 208; C&E, p. 702-03.

d. Phantom stock: ***"Phantom stock"*** is quite similar to an SAR. However, the deferred cash bonus that the executive receives under a phantom stock plan is often equal to the ***total value*** of a share of the company's stock sometime in the future (whereas the SAR only pays him the ***increase*** in that value since the date of grant). Thus a phantom stock plan might entitle Executive to an amount of cash in three years equal to the then market value of 10,000 shares of the company's stock. Executive is not deemed to have received any compensation before the three-year-away settlement date, and he has no voting rights during the interim. He will not receive cash dividends during the interim, but might get some

economic benefits from dividends (by having these treated as if he had reinvested them in more phantom stock). Clark, p. 208; C&E, p. 703-04.

3. **Pensions and other long-term deferred compensation:** Corporations also typically have long-term ***deferred*** compensation plans for senior executives. Most common is the ***pension plan*** or retirement plan, by which the executive will receive regular cash payments during retirement. If the retirement plan is qualified under the Internal Revenue Code, the company gets a current deduction for money it puts into the plan, the money inside the plan compounds tax-free, and the executive is not taxed until he actually starts receiving the cash payments following his retirement.

C. Corporate law problems: We're now ready to analyze the corporate-law issues which are raised by compensation schemes benefiting senior executives or directors. There are three main issues:

(1) How does one avoid the ***self-dealing*** problem, since the executive is influencing the corporation concerning his own compensation level?

(2) Must there be ***"consideration"*** for the compensation, and if so, what kind? and

(3) May a compensation plan be struck down because it is ***"excessive"***

We consider each of these in turn.

D. The self-dealing problem: There is a self-dealing problem whenever the compensation is fixed for either: (1) a director; or (2) an executive who is sufficiently senior that he can influence the corporation's decision about how much he is to be paid.

1. **General rule:** In general, courts treat the self-dealing problems concerning compensation pretty much the same as they treat other kinds of self-dealing. Thus according to most courts, an executive or director compensation scheme is much more likely to be upheld if either: (1) a majority of the ***disinterested directors***

have approved it, following disclosure of all material facts about it; or (2) the ***shareholders*** have approved it, following such disclosure.

a. **Fairness as key:** As with other types of self-dealing transactions, the compensation scheme is much more likely to be upheld if in the court's judgment it is ***"fair"*** to the corporation. In the compensation context, the question, "Is the scheme 'fair' to the corporation?" becomes transformed into the question, "Is the compensation 'excessive'?" Excessive compensation is discussed *infra*, p. 216.

b. **Shift of burden of proof:** As with other types of self-dealing, if the disinterested directors or shareholders have approved the scheme, a much greater showing of unfairness will be needed to strike the plan, and the burden of persuasion shifts from the executive to the person attacking the plan. See, e.g., ALI Prin. Corp. Gov., 5.03(b).

c. **Presence of executive:** If the corporation wants to take advantage of the extra protection from "approval by disinterested directors," the executive should usually not only not take part in the directors' vote on his compensation, but he should not even ***be present*** at the meeting. Clark, p. 194.

2. **Business judgment rule:** The importance of approval by disinterested directors or shareholders is shown by the fact that in many courts, the disinterested directors' decision to approve a scheme will be awarded the protection of the ***business judgment rule***. Under the business judgment rule (see *supra*, p. 182), the directors' decision will be sustained by the court so long as it is rational, informed, and in good faith (despite the fact that the court might have reached a different conclusion about the desirability of the action).

E. **Consideration:** Courts insist that there be ***consideration*** for each element of a compensation plan. In the case of salary and current bonus, the consideration is clear: the executive is working for the company for a particular period, and is being paid for the period.

1. **Deferred compensation:** The requirement of consideration has real bite, however, when the compensation plan includes stock options, retirement benefits, or other consideration that is to be paid far in the future. In brief, the requirement of consideration means that it must be ***very likely*** that an executive will receive the deferred compensation ***only if he remains with the company***. For instance, a grant of stock options to all executives currently at the company, exercisable by them in the future regardless of whether they have remained with the company following the adoption of the option plan, would probably be struck down as lacking in consideration.

2. **Unbargained-for payments for past services:** Another situation in which the requirement of consideration may have some bite is where the corporation makes a large payment upon the ***death*** or ***retirement*** of a senior executive, without there having been a ***prior plan*** or ***contract*** to make such a payment. Although the corporation may defend such a payment on the grounds that the consideration was the "past services" of the executive, the challenger can make the following argument: Where there was no contract or plan to make the payment, the executive could not have been motivated by the prospect of receiving it while he was still working, so the payment amounts to a gift or a waste of corporate assets. Courts have sometimes accepted this argument, and have struck down large payments, made without a pre-existing plan or contract, to senior executives or their estates at retirement or death.

   a. **Ways around:** Observe that there are a number of ways around this problem. Most obviously, the corporation can enact a formal plan of retirement or death payments while the executive is still active; his continued participation until death or retirement is therefore the consideration for the eventual payment. Second, even if there has not been advance planning, the executive can receive payments in retirement (though probably not after death) under a "consulting" contract or a non-competition agreement. Clark, p. 197.

F. **Ban on "excessive" or "unreasonable" compensation:** Even if a

compensation scheme has been approved by a majority of the disinterested directors, or ratified by the shareholders, the court may still overturn it if the level of compensation is ***"excessive"*** or ***"unreasonable."*** As the idea is usually put, "the amount of compensation must bear a ***'reasonable relationship'*** to the ***value of the services*** performed for the corporation." Clark, p. 192.

1. **Easier to satisfy than "fairness" rule:** Recall that for most types of self-dealing transactions, the court will strike down transactions it believes to be ***"unfair"*** to the corporation. In the compensation area, the courts are more reluctant to strike down the transaction: it is harder to show that a compensation level is "excessive" than it is to show that a different sort of transaction is "unfair": "Executive compensation is scrutinized in a less exacting way than are other contracts with interested officers." *Id.*

   a. **Rationale:** The main reason for this judicial reluctance to strike down compensation as excessive is that courts feel they do not have the appropriate ***standards*** by which to judge the reasonableness of compensation. As one court put it, "[W]hat yardstick is to be employed? Who or what is to supply the measuring-rod? … If comparisons are to made, with whose compensation are they to be made — Executives? Those connected with the motion picture industry? Radio artists? Justices of the Supreme Court of the United States? The President of the United States? … [I]f a ceiling for these bonuses is to be erected, the stockholders who built and are responsible for the present structure must be the architects." *Heller v. Boylan*, 29 N.Y.S.2d 653 (1941).

2. **Few cases:** Consequently, there are relatively ***few*** cases in which courts have struck down executive compensation plans as being "excessive." At least where the compensation plan has been approved by disinterested directors or ratified by disinterested shareholders, courts will generally invalidate it only if it is so excessive as to constitute ***"waste."***

   a. **Standard for "waste":** The typical definition of "waste" is a

very ***restricted*** one. Thus in Delaware, a transaction will not be invalidated as constituting waste unless it is "an exchange that is ***so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."*** *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). In the case of executive compensation, "If … there is ***any substantial consideration received*** by the corporation, and if there is a ***good faith judgment*** [by the board] that in the circumstances the ***transaction is worth while***, there should be no finding of waste, even if the fact finder would conclude ex post that the transaction was ***unreasonably risky***." *Brehm*, *supra*.

Example: Consider the facts of *Brehm*, *supra*, p. 175: the board of Disney gives Michael Ovitz a contract which, when terminated early by the company without any breach on the part of Ovitz, gives Ovitz a severance payment of $140 million. Notwithstanding the huge expense and the near-total lack of value actually received by Disney from having Ovitz as its president, the Delaware Supreme Court held as a matter of law that the Disney board did not commit waste in entering into the contract. The board had decided that an expensive compensation package would be required for Ovitz to take the job, and that he would be valuable to the company. Because "the size and structure of executive compensation are inherently matters of judgment," the board's decision could be labeled as waste only if the board acted irrationally or in good faith. And, here, the plaintiff had not "alleged with particularity" facts that would prove either irrationality or lack of good faith.

3. **Tax cases about compensation:** The strong reluctance of courts to strike down compensation as excessive under corporate law principles should be contrasted with the result in many ***tax*** cases. Under §162 of the Internal Revenue Code, a corporation may deduct from its gross income its ordinary and necessary business expenses, including a "reasonable allowance for salaries or other compensation for personal services actually rendered."

Quite frequently, the IRS attacks a particular manager's compensation as "excessive," and the courts have often agreed. In the tax context, the courts have focused on comparable compensation, i.e., how much executives who perform similar functions for similar companies earn. They do not seem troubled by the difficulty of making such comparisons (in contrast to the difficulties in making comparisons that the court in *Heller v. Boylan*, *supra*, p. 217, felt it faced). See generally, Clark, pp. 199-200.

Quiz Yourself on
THE DUTY OF LOYALTY *(EXECUTIVE COMPENSATION)*

50. Mr. Bill is president of Sluggo Storage Systems, Inc. He earns $150,000 per year in that post. The company has no provision for a pension or death benefit for Mr. Bill (or for any other worker). Mr. Bill is killed in a freak accident when he is run over by a steamroller. At the next board meeting, the board unanimously votes to pay Mrs. Bill, Mr. Bill's widow, an annual pension of $75,000.

(a) You represent Spot, a minority shareholder of Sluggo. Spot is not too happy about the pension, but can't think of any grounds upon which to object. What grounds would you recommend?

____

(b) Will the grounds for objection that you recommended in part (a) be successful? ______________________________

Answers

50. (a) Lack of consideration. The issue here is the validity of payments for past services. The general rule from contract law is that such payments are only valid when the basic specifics of the arrangement and the recipient's identity are established *before* the services are rendered (in the form of a contract, a formal bonus plan, or established company practice). Otherwise, such payments are without consideration, since "past consideration" is not consideration at all.

(b) Yes, probably. Mr. Bill was dead before the specifics of the pension were ever worked out, so the pension couldn't have been consideration for his performance of services while alive. Consequently, the court will probably order that the pension not be paid. (Alternatively, the court might say that paying a pension for which there is no consideration is a "waste" of corporate assets, since the corporation receives no benefit from the payment.)

IV. THE CORPORATE OPPORTUNITY DOCTRINE AND RELATED PROBLEMS

A. Introduction to problem: So far in our treatment of the duty of loyalty, we have focused on transactions between the Key Player and the corporation. We turn now to a different type of problem: the Key Player appropriates to himself some ***business opportunity*** or ***property*** that is found to "***belong" to the corporation***. Here, there is rarely an issue as to the "fair" price; instead, if the Key Player has taken something that belongs or ought to belong to the corporation, this is *per se* wrongful and the corporation may recover. There are three sub-problems:

[1] When may a Key Player ***compete*** with the corporation?

[2] When may a Key Player make ***personal use of corporate assets*** (e.g., by using the company plane to fly on a personal vacation)? and

[3] When does a Key Player, by taking advantage of a business opportunity, wrongfully usurp a ***"corporate opportunity"***?

Of these three areas, the third is the most difficult and important. We consider each in turn.

B. Competition with the corporation: A director or senior executive ***may not compete*** with the corporation, where this competition is likely to ***harm*** the corporation.

Example: Able and Baker are both senior vice presidents

of Wannabe's, a large department store in downtown Cleveland. While they are on the Wannabe's payroll, they secretly form a new corporation, Newco, and cause Newco to sign a lease on a vacant building across the street from Wannabe's. They intend to set up a competing department store in this building. They then (still while on the payroll) tell some key suppliers that they'll be opening up a competing department store soon, and that they hope to buy from these suppliers. Able and Baker also tell their plans to two of Wannabe's key executives, Charlie and Devon, saying, "We hope you'll come with us in a month or so after we open the new store." This induces Charlie and Devon to work less hard for Wannabe's, since they figure that they, too, will soon be leaving to join the new store.

A court would probably hold that Able and Baker have violated their duty of loyalty to Wannabe's, by effectively competing with Wannabe's while still on the payroll. If so, the court will probably order them to pay money damages to Wannabe's (and might — though probably won't — enjoin them from soliciting any further employees from Wannabe's for some period of time.)

1. **Seek approval or ratification:** But as with other types of self-dealing, conduct that would otherwise be prohibited as disloyal competition may be validated by being ***approved*** by disinterested directors, or being ratified by the shareholders. With either of these methods, the Key Player must first make ***full disclosure*** about the conflict of interest and the competition that he proposes to engage in. See ALI, Prin. Corp. Gov., §5.06(a)(2) and (a)(3). Thus had Able and Baker gone to the directors of Wannabe's in the above example, and announced that they wished to own a competing store, and had the disinterested directors approved of this by a majority vote, there would have been no violation of the duty of loyalty.

2. **Preparation to compete while still in corporation's employment:** Executives and directors seldom engage in active competition while still affiliated with the corporation. Much

more commonly, they ***prepare***, while still on the company's payroll, to engage in later competition. For instance, they may acquire property that will be used in competing, hire employees, negotiate contracts, solicit customers for the soon-to-be-born firm, or otherwise pave the way. There are no hard and fixed rules for this situation, but in general courts tend to hold that these activities constitute disloyalty if they occur while the director or executive is still on the original corporation's payroll. A common remedy is for the court to order a ***return of all salary*** received during this preparation period.

3. **Competition after end of employment:** A quite different situation is presented where the executive or director first ***leaves the corporation*** and only then begins preparing to compete. Assuming that the executive has not signed any "non-compete" agreement, he is ***not barred*** from basic competition with his former employer.

   a. **Trade secrets:** However, he may not compete by the taking of the former employer's ***trade secrets***. Any of the following acts may be deemed to be a wrongful taking of trade secrets: (1) the systematic solicitation of a large number of the former employer's ***customers***; (2) the solicitation of the former employer's ***employees*** to become employees of the new company; and (3) the use of the former employer's secret ***processes*** or other methods of doing business.

   b. **Non-compete:** Additionally, the executive may be barred from competing if he has signed a valid ***non-competition agreement***. However, courts have become increasingly reluctant to enforce broad non-competition agreements, because they do not wish to unduly constrict the executive's ability to earn a living. Therefore, non-competition covenants will be enforced only if they are ***reasonable*** as to ***time***, ***area***, and ***scope***. H&A, p. 630.

      i. **Illustration:** For instance, suppose a dentist agrees with his employer not to compete by practicing dentistry at any place in New York City for a period of two years following

the end of his employment; this would almost certainly be found to be too broad to be enforceable. But a promise not to practice oral surgery for six months in the same small town as the employer, by contrast, would probably be upheld.

C. Use of corporate assets: A Key Player may not ***use corporate assets*** if this use either harms the corporation, or gives the Key Player a ***financial benefit*** (including a financial benefit he receives as a stockholder that is not available to other similarly-situated stockholders). See ALI Prin. Corp. Gov., §5.04(a) (reprinted *infra* p. 261). "Corporate assets," for this purpose, consist not only of tangible goods but also intangibles like ***information***.

> **Example:** D, the engineering director of a large aerospace company, learns that the company will be making huge purchases of platinum for a secret project. Only a few people inside the company (and no one outside of it) know that this will occur. D buys platinum futures, and when the news is announced, D sells at a substantial profit. A court might well hold that D has wrongfully used a corporate asset (information about the corporation's plans), in which case the corporation would be entitled to the profits rather than D.

1. Approval or payment: As with other types of self-dealing, ***approval*** by disinterested directors, or ***ratification*** by shareholders (in each case, only ***after full disclosure***) will help ***immunize*** the transaction. Similarly, in the case of use of tangible corporate property, the transaction will not be wrongful if the Key Player pays the ***fair value*** for any benefit he has received. See ALI Prin. Corp. Gov., §5.04(a)(1).

D. The "corporate opportunity" doctrine: Suppose that a senior executive or director of a corporation learns of an attractive business opportunity. Suppose further that this business opportunity is not in an area of commerce in which the corporation presently does business. May the executive or director pursue this opportunity on his own, rather than turning it over to the

corporation? The brief, but unhelpful, answer is that the manager may not pursue the opportunity on his own, and must turn it over to the corporation, if the opportunity is one that can be said to ***"belong"*** to the corporation. The difficulty is that the rules for distinguishing between opportunities that "belong" to the corporation and those that do not are confusing, and vary substantially from court to court.

1. Effect of finding of "corporate opportunity": If the manager is found to have taken for himself an opportunity that "belongs" to the corporation (i.e., to have usurped a ***"corporate opportunity"***), the rules are very strict: this taking is ***per se wrongful*** to the corporation, and the corporation may recover damages equal to the loss it has suffered, or the profits it would have made had it been given the chance to pursue the opportunity. Often, the court will order any profits made by the manager from the venture to be held in ***constructive trust*** for the corporation, and may order the enterprise itself to be turned over to the corporation. See *infra*, p. 229.

> **Example:** D is the president of Hotel Corp. D knows that Hotel Corp is looking for an appropriately zoned two-acre site in the village of Ames on which it can build a hotel. As D knows, the company's search for such a site so far has been notably unsuccessful. D learns through a friend of a good potential site at a fair price. Instead of allowing Hotel Corp to buy the site, he buys it himself, and resells it for a quick profit to a businessman who puts a car dealership on it. The court is likely to find that by buying the land, D has usurped a corporate opportunity, i.e., an opportunity that properly belonged to Hotel Corp. If the court does so conclude, it will order D's profit on the resale to be turned over to Hotel Corp. (And, in fact, if Hotel Corp is unable to get another site, D may even be liable to pay a larger sum equal to the profits that Hotel Corp could have made had it been offered the site and built a hotel there.)

a. No issue of fairness of price: Once the court decides that the manager has taken a corporate opportunity, most courts ***do not***

recognize any separate issue of "fairness." Thus suppose Manager buys Blackacre which, the court finds, he should have offered to the corporation that employs him. The fact that Manager has paid a fair market price for the property (and the fact that a subsequent increase in value is due to an unforeseen increase in values, or to Manager's own unusual efforts) is irrelevant — Manager will still have to account to the corporation for any profits he has made.

2. Delaware multi-factor test: Courts vary in the tests they use for whether an opportunity is a "corporate opportunity." The Delaware courts use a ***multi-factor test***, which has been influential in other courts. Therefore, we'll focus on the Delaware test here.

a. The multi-factor test: Under Delaware law, a business opportunity presented to a corporate officer or director will count as a "corporate opportunity" if it meets the following requirements:

- ❏ the corporation is "***financially able to exploit***" the opportunity;
- ❏ the opportunity is "within the corporation's ***line of business"***;
- ❏ the corporation has an ***"interest or a reasonable expectancy"*** in the opportunity; and
- ❏ if the director or officer were to embrace the opportunity, he would thereby be placed in a ***conflict*** with his duties to the corporation.

See *Beam v. Stewart*, 833 A.2d 961 (Del. Ch. 2003), quoting the four-factor test originally set out in *Guth v. Loft*, 5 A.2d 503 (Del. 1939).

i. Either "line of business" or "interest or expectancy": The language quoted above from *Beam* sounds as though the opportunity must satisfy *both* the "line of business" and "interest or expectancy" standards. But in practice, the Delaware courts seem to hold that the

opportunity must merely satisfy *either* the "line of business" or "interest or expectancy" test, not both. Clark, p. 228.

ii. Meaning of "line of business": Delaware cases often turn on the ***"line of business"*** element. The Delaware courts (and the courts of other states following the general Delaware approach) seem to take a fairly ***broad definition*** of line of business. Even if the activity is not a business that the corporation already engages in, the court is likely to find that the line-of-business test is satisfied if the court feels that the company has some ***special expertise*** that equips it to compete in the new area. Thus a ***"functional relationship"*** between the type of activity the corporation already engages in and the prospective activity may be enough, even though they are in different industries.

Example: Clark (p. 228) suggests that if a company already makes cold medicines, a business that makes contact lens wetting solution would be within its "line of business," because "the methods of marketing and distributing the products — through drug stores, for example — overlap … enough to permit ***significant economies of scale*** if the businesses were to be combined."

3. Other factors (especially for determining "fairness"): Apart from the four factors applied under the Delaware test (*supra*, p. 221), there are a number of additional factors which courts consider in deciding whether an opportunity is a corporate one. These factors are especially likely to be considered by a court that uses "fairness" as a partial or sole standard:

a. Capacity in which offer received: whether the opportunity was offered to the officer or director as an ***individual***, or rather as a corporate manager who would convey the offer to the corporation. The case for regarding the opportunity as corporate is obviously stronger in the latter situation than in the former.

b. How insider learned of opportunity: whether or not the officer or director ***learned*** of the opportunity while ***acting in***

his role as the corporation's agent. Thus if President learns of the opportunity while attending a meeting that relates solely to his company's business, the case for finding a corporate opportunity is stronger than where President learns of it while having drinks with a social friend.

c. **Use of corporate resources:** whether the officer or director ***used corporate resources*** to take advantage of the opportunity. An illustration of the use of corporate resources would be where President takes the company jet to scout out the opportunity.

   i. **D's use of his own "company time":** Some corporate plaintiffs have claimed that when the defendant (an employee of the corporation) developed the opportunity while on ***"company time"*** (i.e., during working hours), this constituted the "use of corporate resources." However, this by itself is ***unlikely*** to be a very important factor, especially if the time used is not very substantial.

d. **Essential to corporation:** whether the opportunity is ***essential*** to the corporation's well-being. The more important the opportunity is to the corporation's well-being — i.e., the worse financial injury the corporation will suffer if it does not have the opportunity — the more likely the opportunity is to be regarded as corporate.

   Example: Suppose Realty Corp, a real estate developer, is trying to complete an assemblage on which to build a single skyscraper. If an executive of Realty snatches away the last lot in the parcel, thus preventing Realty Corp from completing its assemblage, the critical importance to Realty of this last lot makes it very likely that a court will view the lot as an opportunity belonging to Realty.

e. **Distinction between outside director and full-time executive:** whether the person taking the opportunity is an ***outside director*** or a ***full-time executive***. A full-time ***executive*** is commonly understood to owe his ***entire efforts and loyalties*** to the corporation that employs him. An ***outside***

director, by contrast, often has numerous other business interests, some of which will be (and may properly be) more financially important to him than the corporation that he serves only as a director. Therefore, the outside director should be ***more free*** to take an opportunity for himself.

i. **ALI approach:** The ALI's *Principles of Corporate Governance* recognize this distinction:

(1) **Employee:** Under §5.05(b), an opportunity is a corporate one if it comes to a ***full-time employee*** who knows that the opportunity is ***"closely related*** to a business in which the corporation is engaged or expects to engage."

(2) **Outside director:** If the opportunity comes to an ***outside director***, by contrast, the fact that he knows or should know that the opportunity is closely related to the corporation's present or reasonably anticipated activities is ***irrelevant***; the opportunity is not deemed "corporate" unless the director either: (1) learned of the opportunity ***in connection*** with performing his duties for the corporation; (2) learned of it under circumstances where he should reasonably have believed that it was ***really being offered to the corporation*** and not to him personally; or (3) learned of it through the use of ***information or property belonging to the corporation*** (in which situation a full-time employee will also have to treat the opportunity as "corporate.")

See *infra*, p. 227, for a more complete description of the ALI approach to corporate opportunity.

4. **Delaware's "no need for pre-approval by corporation" rule:** Suppose that the Key Player (officer or director) who has the opportunity believes that under the relevant test (e.g., the multi-factor Delaware test described above, *supra*, p. 221), the opportunity is not a corporate one. Must the Key Player ***disclose*** the opportunity to the board of the corporation ***in advance***, and give the latter the chance to argue that this is indeed a corporate

opportunity that the corporation wishes to pursue? At least in Delaware, the answer is a clear ***"no"*** — the Key Player is always *free* to disclose the opportunity and try to get the corporation to say that it's not interested, but the Key Player is ***not required*** to make advance disclosure.

a. Significance: Of course, if the Key Player *doesn't* make advance disclosure, and takes the opportunity for herself, she faces the risk that if the opportunity proves lucrative, the corporation will sue the Key Player and try to unwind the transaction or collect the profits from it. If that happens, then a court will then second-guess the Key Player's judgment that the requirements of the opportunity doctrine were not satisfied. But the Key Player is entitled to take this risk — there is no formal requirement of advance disclosure, at least in Delaware.

Example: Broz is a director of CIS, a publicly-held corporation that offers cellular service in various parts of the country. Broz also owns his own smaller cellular provider, RFBC. Broz learns of the availability of an FCC license called "Michigan-4," entitling the holder to provide cell service in a rural part of Michigan. Broz speaks informally to a couple of CIS directors, and learns that they do not believe CIS would have an interest in the Michigan-4 license. However, Broz does not present the opportunity formally to the entire board of CIS. Instead, Broz causes his own company, FRBC, to buy the license. In so doing, he beats out a competing offer from PriCellular, another cellular provider that is at the time in early discussions about merging with CIS. Shortly after Broz causes FRBC to buy the license, PriCellular and CIS in fact merge. The management of the combined CIS/PriCellular then asserts that the Michigan-4 opportunity was a corporate opportunity of CIS, and that Broz was required to present the opportunity formally to the board of CIS before buying it for himself.

Held, for Broz. First, at the time Broz purchased, CIS

was divesting most of its cellular operations, so the company did not have any "expectancy" regarding any new license. Second, it is irrelevant that Broz did not formally offer the opportunity to CIS' board: "It is not the law of Delaware that presentation to the board is a necessary prerequisite to a finding that a corporate opportunity has not been usurped." And the fact that there was some chance that CIS might complete a merger with PriCellular (which as Broz knew wanted the opportunity for itself) is irrelevant, since it was unclear that the merger would ever go through, or that Pri-Cellular might want the opportunity post-merger. *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996).

5. **Who is bound:** Generally, courts seem to apply the corporate opportunity doctrine only to ***directors***, ***full-time employees***, and ***controlling shareholders***. Thus a shareholder who has only a ***non-controlling interest*** (and who is not a director or employee) will generally ***not*** be subjected to the doctrine.

   a. **Lower-level employee:** There are not many corporate-opportunity cases involving ***lower-level employees***. However, such an employee probably has a ***similar duty*** to refrain from usurping a corporate opportunity, under the law of agency (which makes an employee a fiduciary for the employer). See *ALI Principles*, Introductory Note to Part V, sub-par. (b).

      i. **Less likely to be "unfair":** However, when a low-level employee takes a given opportunity for himself, the taking is probably somewhat ***less likely*** to be found to be ***"unfair"*** to the corporation than where the taking is by, say, an officer. So to the extent that the jurisdiction considers "fairness" in deciding whether something is a corporate opportunity, the low-level employee is likely to have an easier time.

6. **Rejection by corporation:** Even if an opportunity is a "corporate opportunity," the Key Player is not necessarily barred from pursuing it himself. If he ***offers the corporation*** the chance

to pursue the opportunity, and the corporation ***rejects the opportunity*** by a majority vote of ***disinterested directors*** or ***disinterested shareholders***, the Key Player may pursue the opportunity himself. S,S,B&W, pp. 809-10. See also ALI Prin. Corp. Gov., §5.05(a)(3)(B) and (C).

a. **Disclosure:** In order for the Key Player to be allowed to raise the defense that the disinterested directors or shareholders have rejected the opportunity on behalf of the corporation, most courts require that the Key Player have made ***full disclosure*** of the nature of the opportunity. Thus if President purports to offer the corporation the chance to pursue the opportunity but ***understates*** the potential benefits, or overstates the cost to the corporation, rejection by the disinterested directors or disinterested shareholders will probably not be a defense. See ALI Prin. Corp. Gov., §5.05(a)(1).

b. **Contemporaneous vs. subsequent rejection:** The safest path is for the Key Player to offer the opportunity to the corporation ***before*** he accepts it himself, and to wait until the disinterested directors or shareholders have rejected it before he acts. But if the Key Player accepts the opportunity himself, and then persuades the disinterested directors or shareholders to ***ratify*** his acceptance (and the corporation's rejection) of the opportunity after the fact, this post-facto ratification may ***still be enough*** to allow the Key Player to escape liability.

   i. **Close scrutiny:** However, courts probably would scrutinize such an after-the-fact ratification ***more closely*** on the theory that it is far less likely to manifest a truly voluntary consent than where the opportunity is offered to the corporation in advance, at a time when the corporation may truly benefit from it.

   ii. **ALI:** In fact, the ALI's Principles are stricter than most courts on this issue; under the ALI approach, there is a flat rule against a director's or senior executive's taking a corporate opportunity unless the opportunity has first been

disclosed and offered to the corporation and rejected by it. In other words, under the ALI text, the director or senior executive may not take a corporate opportunity with no disclosure to the corporation, then receive after-the-fact ratification by disinterested directors or shareholders.

7. **Corporation's inability to take advantage of opportunity:** A Key Player who takes a corporate opportunity for himself often tries to defend the subsequent lawsuit by contending that the corporation would have been ***unable*** to take advantage of the opportunity itself, and has therefore suffered no damage. This is a troublesome defense, since if the court allows it, the Key Player will have absolutely no incentive to help the corporation overcome its difficulties — he will simply take the opportunity for himself, and count on being able to make a later showing of corporate inability, a showing which is likely to be quite difficult for outsiders to disprove. Clark, p. 243.

   a. **Types of inability:** There are a number of different types of corporate inability that Key Players have raised when sued for usurping a corporate opportunity: (1) the corporation's ***legal*** inability (e.g., because of antitrust or other regulatory restraints); (2) the ***refusal*** by the person offering the transaction to deal with the corporation; and (3) the corporation's ***financial*** inability to take advantage of the opportunity. Courts are especially reluctant to accept justifications of type (3), since if the opportunity is a good one, there should be a way to overcome financial constraints (e.g., by convincing a bank or other investor to lend money, by taking on a partner, by forming a joint venture, etc.) Clark, p. 243.

   b. **Strict rule:** Courts are in disagreement about whether and when the defense of corporate inability should be accepted. A number of courts take a quite strict view, under which if the Key Player does not make full disclosure to the corporation and offer it the opportunity, he is ***simply not permitted to argue*** that the corporation could not have taken advantage of the opportunity. This "bright line" rule has the advantage of

encouraging full disclosure (and honest efforts by the Key Player to help the corporation take advantage of attractive opportunities).

i. ALI: As noted, this is the approach followed by the ALI's *Principles of Corporate Governance*: If the Key Player does not offer the opportunity to the corporation, and make full disclosure about it, his taking of that opportunity for himself is flat-out wrongful, even if the corporation would have been totally unable to take advantage itself.

Example: D is the president of P, a corporate "club" that owns a golf course. On several occasions, D buys parcels of real estate that immediately adjoin the course. After each purchase, D informs the board of P that she has made the purchases; the board takes no action (it neither affirmatively votes to ratify D's purchases nor does anything to oppose or undo them.) More than 10 years after the earliest of these purchases, the board finally sues D to have the parcels held in trust for the club, on the theory that D usurped a corporate opportunity. D defends, in part, on the theory that the club never had the funds to have purchased the parcels when they became available.

Held (on appeal), for P: the case is remanded for a rehearing by the trial court, with the ALI principles to be applied. If the trial court concludes (as P alleges) that one or more of the parcels was offered to D in her capacity as club president, the opportunity must be found to be a corporate one. Assuming that D did not make disclosure to the board of the opportunity until after she bought the parcels, and that the board did not thereafter affirmatively ratify her conduct, then D will not be permitted to defend on the grounds that her failure to offer the opportunity was "fair" (e.g., fair because the club was not financially able to exercise the opportunity itself). "The central feature of the ALI test is the strict requirement of full disclosure prior to taking advantage of any corporate opportunity." (On remand, the trial court concludes that D did indeed usurp a

corporate opportunity, but that no recovery is allowable, because of statute-of-limitations and laches problems.) *Northeast Harbor Golf Club, Inc. v. Harris*, 661 A.2d 1146 (Me. 1995).

(1) Where Key Player *does* make offer to corporation: On the other hand, if the Key Player *does* offer the opportunity to the corporation and the disinterested directors or shareholders reject it, the corporation's financial, legal or other inability to take advantage of the opportunity *are* to be considered as factors in determining whether they acted "rationally" in rejecting, an additional requirement for the "rejection" defense. See Comment to §5.05(a).

c. Lenient view: Other courts, such as those of Delaware, take a more lenient view toward the defense of corporate inability than does the ALI test. For instance, in *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939), the court treated an opportunity as being a "corporate opportunity" only if the opportunity was one "which the corporation is financially able to undertake." Delaware courts have continued to apply this standard, and to hold that there is no requirement of advance disclosure if the corporation is not in fact financially able to exploit the opportunity.

8. ALI approach: The ALI's *Principles of Corporate Governance* are by far the most comprehensive statutory or statute-like treatment of the problems of the corporate opportunity doctrine. (By contrast, the MBCA doesn't deal specifically with the corporate opportunity doctrine at all, and leaves this area to case law.) Because of the specificity of the ALI treatment, and its growing acceptance by courts, we reproduce the relevant sections:

§5.05 Taking of Corporate Opportunities by Directors or Senior Executives

(a) *General Rule.* A ***director*** or ***senior executive*** may not take advantage of a ***corporate opportunity*** unless:

(1) [He or she] first ***offers*** the corporate opportunity to the corporation and makes ***disclosure*** concerning the conflict of interest and the corporate

opportunity;

(2) The corporate opportunity is ***rejected*** by the corporation; and

(3) Either:

(A) The rejection of the opportunity is ***fair*** to the corporation;

(B) The opportunity is rejected in ***advance***, following such disclosure, by ***disinterested directors*** … in a manner that satisfies the standards of the ***business judgment*** rule; or

(C) The rejection is ***authorized*** in advance or ratified, following such disclosure, by ***disinterested shareholders***, and the rejection is not equivalent to a ***waste*** of corporate assets.

(b) *Definition of a Corporate Opportunity.* For purposes of this Section, a corporate opportunity means:

(1) Any opportunity to engage in a business activity of which a ***director*** or ***senior executive*** becomes aware, either:

(A) ***In connection with the performance*** of functions as a director or senior executive, or under circumstances that should reasonably lead the director or senior executive to believe that the person offering the opportunity ***expects it to be offered to the corporation***; or

(B) Through the use of ***corporate information or property***, if the resulting opportunity is one that the director or senior executive should reasonably be expected to believe ***would be of interest*** to the corporation; or

(2) Any opportunity to engage in a business activity of which a ***senior executive*** becomes aware and knows is ***closely related*** to a business in which the corporation is engaged or ***expects*** to engage.

• • •

§5.12 Taking of Corporate Opportunities by a Controlling Shareholder

(a) *General Rule.* A ***controlling shareholder*** may not take advantage of a corporate opportunity unless:

(1) The taking of the opportunity is ***fair*** to the corporation; or

(2) The taking of the opportunity is ***authorized in advance or ratified*** by disinterested shareholders, following ***disclosure*** concerning the conflict of interest and the corporate opportunity, and the taking of the opportunity is not equivalent to a ***waste*** of corporate assets.

(b) *Definition of a Corporate Opportunity.* For purposes of this section, a corporate opportunity means any opportunity to engage in a business activity that:

(1) Is ***developed or received by the corporation***, or comes to the controlling shareholder primarily by virtue of its relationship to the corporation; or

(2) Is ***held out*** to shareholders of the corporation by the controlling shareholder, or by the corporation with the consent of the controlling shareholder, as being a type of business activity that will be ***within the scope of the business*** in which the corporation is engaged or expects to engage and will not be within the scope of the controlling shareholder's business.

(c) *Burden of Proof.* A party who ***challenges*** the taking of a corporate opportunity has the ***burden of proof***, except that the ***controlling shareholder*** has the burden of

proving that the taking of the opportunity is ***fair*** to the corporation if the taking of the opportunity was ***not authorized in advance or ratified by disinterested directors or disinterested shareholders***, following the disclosure required by Subsection (a)(2).

a. Special features: Following are a few of the especially noteworthy features of the ALI's treatment of corporate opportunity. (We've touched on some of these above, but for convenience, we discuss the whole ALI approach here in a single place.)

b. Requirement of advance disclosure: If the opportunity is a "corporate opportunity," the insider (director, senior executive or "controlling shareholder") ***must offer it to the corporation***, with full disclosure of its nature before he may take it for himself. If he does not make this offer, he will not be permitted to defend a later suit on the grounds that the corporation was unable (for financial or other reasons) to take advantage of the opportunity. As one court has said in adopting the ALI approach, "the central feature of the ALI test is the strict requirement of ***full disclosure*** prior to taking advantage of any corporate opportunity." *Northeast Harbor Golf Club, Inc. v. Harris, supra*, p. 226.

c. Disinterested directors or shareholders: The mere fact that the corporation rejects the opportunity does not by itself get the Key Player off the hook. Unless the corporation's rejection is ***authorized*** by a majority of ***disinterested directors***, or a majority of ***disinterested shareholders*** (in either case, following full disclosure), the Key Player will have to show that the corporate rejection and the overall transaction were ***fair to the corporation.***

i. Effect of director authorization: On the other hand, if a majority of disinterested directors ***does*** authorize the rejection, then the transaction is pretty much ***immunized*** against later attack. Only if the disinterested directors have violated the business judgment rule (i.e., they have behaved irrationally; see *supra*, p. 188) may the transaction be attacked.

ii. Effect of shareholder authorization: Similarly, if a majority of disinterested ***shareholders*** approves the corporation's rejection of the opportunity after full disclosure, the transaction may be attacked only if their action amounts to "waste."

d. Senior executive has stricter duty: As noted, *supra*, p. 226, a ***"senior executive"*** (i.e., a ***full-time*** high-level employee) is held to a somewhat ***stricter standard*** than an outside director. Any opportunity of which the senior executive becomes aware (even if this happens outside of the corporation's business, as at a purely social cocktail party) is "corporate" if the executive "knows [that the activity] is closely related to the business in which the corporation is engaged or expects to engage." §5.05(b)(2). By contrast, if the outside director learns of the opportunity, and does so while not acting either on behalf of the corporation or by use of corporate information, the opportunity is not a "corporate" one. §5.05(b)(1).

e. Controlling shareholder: A ***controlling shareholder*** is treated more like a senior executive than like an outside director. The opportunity is a "corporate" one as to the controlling shareholder if either: (1) she learns of it while ***acting on the corporation's behalf***; or (2) or the opportunity is one that is "***held out to the [other] shareholders*** of the corporation" as being "a ***type of business activity*** that will be within the scope of the business in which the corporation is engaged or expects to engage and will not be within the scope of the controlling shareholder's business." (§5.12(b)(2).)

Example: Major is the controlling shareholder of newly-formed Corp, which is to invest in Connecticut real estate. Major also has a separate business that invests in real estate. Major tells his fellow investors, "I'll use my contacts to find good Connecticut real estate investments for Corp." No matter how Major learns of a particular Connecticut real estate investment, it will be a "corporate" opportunity, because Major has indicated to his fellow shareholders that such opportunities will be for Corp rather than for any other

businesses in which Major is involved.

9. **Parent-subsidiary problems:** Suppose one corporation owns a controlling (but not 100%) interest in another corporation. In this ***parent-subsidiary*** context, suppose that the parent decides to take a business opportunity for itself rather than for the subsidiary. Does the corporate opportunity doctrine apply? In brief, the answer is probably "yes" — if the opportunity relates much more closely to the subsidiary's present or contemplated business than to the parent's, the parent probably violates its fiduciary obligation to the subsidiary and the subsidiary's minority shareholders by usurping it for itself. This problem is discussed more fully in the treatment of general parent-subsidiary fiduciary questions *infra*, p. 243.

10. **Remedies:** Once the court has determined that a Key Player has usurped what is properly viewed as a corporate opportunity, what ***remedies*** are available to the corporation or its shareholders? The usual remedy is quite draconian: the court may order the imposition of a ***constructive trust***, and may order the Key Player to account for ***all profits*** earned from the opportunity.

    a. **Constructive trust:** If the court imposes a ***constructive trust***, this means that the property is treated ***as if it belonged to the corporation*** that owned the opportunity. The court probably may, but need not, require the corporation to pay the Key Player for the Key Player's direct investment made in creating the opportunity.

    b. **Accounting for profits:** Also, the court will usually order the Key Player to ***account for the profits*** already made from usurpation of the corporate opportunity.

Quiz Yourself on ***THE DUTY OF LOYALTY*** *(THE CORPORATE OPPORTUNITY DOCTRINE)*

51. Mona Lisa Burgers, Inc. — "the burgers with the mysterious sauce" — is an enormous (and rapidly expanding) fast-food chain. Mike Angelo owns 5% of Mona Lisa's outstanding shares, which are publicly traded. Mike is not an officer or director of Mona Lisa, however. Mike knows (as anyone who reads the local business press would know) that Mona Lisa is considering putting a restaurant into the fast-growing suburb of David. Through friends on the David Township planning and zoning board, Mike learns the location of a new freeway that is about to be built through David. He snaps up nearby real estate, knowing that traffic will skyrocket, as will the value of the property. Mike never offers the property to Mona Lisa. Instead, he opens a fast-food restaurant of his own, Sistine Chicken & Ribs.

(a) Mona Lisa sues Mike for usurpation of a corporate opportunity, claiming (quite accurately) that the land would be ideal for a Mona Lisa burger joint. Is Mike likely to be liable? ____________________________

(b) Would Mike be liable if, in addition to the above facts, Mike were an outside (i.e., non-employee) director of Mona Lisa?

____

(c) Would Mike be liable if he was not a director or stockholder at all, but was Mona Lisa's Senior Vice President in charge of sales and marketing? ____________________________

52. Alexis Colby is a director (but not an employee) of the Prime-Time Suds Oil Company. Because Alexis is proud of being exceptionally knowledgeable about the company's affairs, she annually (and at her own expense) takes a tour of some of Prime-Time's properties. While on one such trip to South America, she learns of mineral rights available in Antarctica that seem to have promise for oil. Alexis buys the mineral rights for herself, drills, and finds oil. Has Alexis usurped a corporate opportunity belonging to Prime-Time? ____________________________

53. Peter Pan is a senior employee, and one of seven board members, of the huge, public Darling Pharmaceuticals Company. Darling's area of focus is cancer treatment and prevention. Peter Pan learns about research at Hook University concerning "fairy dust," whose main value is that it makes people fly, but whose secondary value is that people who take it and fly are less likely to get cancer. Peter thinks that fairy dust represents

a great commercial opportunity. He calls the chairman and 5% owner of Darling Pharmaceuticals, Wendy Darling, and discusses the opportunity with her at length (making full disclosure of what he thinks the benefits will be). Peter finally says, “So, whaddya think? Shouldn’t Darling Pharmaceuticals be in on a deal like this?” Wendy pauses and says, “Naaaah. You take it.” Peter buys the rights to fairy dust for himself, and it quickly becomes wildly successful. The corporation sues Peter on grounds of usurping a corporate opportunity.

(a) If you represent Peter, what defense will you raise? ______________________________

(b) Will this defense be successful? ______________________________

(c) Suppose fairy dust merely helps people fly, but doesn’t prevent cancer. Assuming that the defense you raised in part (a) is unavailable, has Peter usurped a corporate opportunity? ______________________________

54. Peter Minuit is vice president of the New England Potato Company, which owns vast tracts of land in New York on which it grows potatoes. He learns through friends that Chief Firewater is willing to sell Manhattan Island, prime potato-growing land in New York, for $24. Peter knows that New England Potato is hard-pressed financially, doesn’t have $24 on hand, and probably couldn’t borrow it from a bank. He therefore doesn’t mention the opportunity to New England Potato’s board or president, and instead buys Manhattan with his own funds, with an eye toward putting a big apple orchard there. New England Potato sues Peter for usurpation of a corporate opportunity.

(a) If you represent Peter, what’s the main defense that you should raise. ______________________________

(b) Is this defense likely to be successful? ______________________________

Answers

51. (a) No, because Mike doesn’t owe Mona Lisa a fiduciary duty on these facts. The rule as to corporate opportunities is essentially that

"insiders" may not exploit an opportunity that rightly belongs to the corporation. Only directors, employees and controlling shareholders will generally be deemed to be bound by the corporate-opportunity doctrine. [224] The mere fact that Mike owns 5% of the shares won't be enough to make him a controlling shareholder (and there's nothing else to indicate he controls the corporation); since he's also not a director or employee, he's free to buy the land without regard to whether it might be a valuable opportunity for the corporation.

(b) No, probably. If Mike were a director, he'd be barred from taking anything that was a true corporate opportunity. But the land here probably wouldn't be deemed to be a corporate opportunity. Where the Key Player is a director (but not an employee), fewer things are deemed to be corporate opportunities. Thus the ALI's *Principles* say that, vis-a-vis a director, something is a corporate opportunity only if the director either (1) learned of the opportunity in connection with performing his duties for the company; (2) learned of it under circumstances where he should reasonably have believed it was being offered to the corporation, not to him personally; or (3) learned of it through the use of information or property belonging to the corporation. [223] Since the facts suggest that Mike learned of the land (and of the routing of the highway) through means that had nothing to do with Mona Lisa or his director-work for Mona Lisa, the land did not represent a corporate opportunity. Consequently, the fact that the land might have been very useful to the company is irrelevant.

(c) Yes, probably. More things are held to be corporate opportunities when exploited by a full-time employee of the corporation than when exploited by an outside director. Thus the ALI *Principles* say that an opportunity is a corporate one if exploited by an employee who knows that the opportunity is "closely related to a business in which the corporation is engaged or expects to engage." [223] Since Mona Lisa is currently engaged in the business of putting up fast-food restaurants on vacant land near highways in fast-growing towns (and has already expressed interest in putting a store in David), this was a corporate opportunity vis a vis a full-time employee. Consequently, Mike was required to offer the property to Mona Lisa first, before buying it himself. (The fact that Mike's area of expertise was sales instead of, say, real-

estate acquisitions, won't make a difference.) The court will probably impose a "constructive trust," under which Mike will be treated as holding the property for Mona Lisa's benefit. [229] (Mona Lisa would have to reimburse Mike for his costs before taking control of the property, however.)

52. Yes, probably. As explored in the previous answer, an opportunity is less likely to be found to "belong" to the corporation when exploited by a non-employee director than when exploited by a full-time employee. But even in the director situation, if the director found the opportunity ***in connection with company business***, the opportunity will generally be held to be a corporate one. [223] Since at the time Alexis learned of the Antarctic opportunity she was visiting company properties in connection with her role as director, that opportunity was a corporate one (which she improperly usurped). (If she had been traveling on a vacation that had nothing to do with Prime-Time affairs, she probably would *not* be deemed to have usurped any opportunity, even though the lease would have been of value to Prime-Time — see the answer to question 48(b).)

53. (a) That the corporation, through Wendy its President, rejected the opportunity.

(b) Probably not. Most courts do indeed hold that if the corporation rejects the opportunity after full disclosure, the Key Player may exploit the opportunity himself. The real issue here is whether "the corporation" has in fact rejected the opportunity. It's true that the President has rejected the opportunity. But most courts would probably hold that rejection does not occur unless either a majority of the disinterested directors, or a majority of the shareholders, have rejected it. [225] Since no disinterested directors other than Wendy have rejected it, true rejection did not occur here.

(c) Probably not. Although the opportunity is drug-related, Darling's focus — cancer — has nothing to do with a drug that merely helps people fly; Darling's marketing channels might not even be useful in selling the product. Thus, this probably wouldn't constitute an opportunity under the line-of-business test, even though "line of business" is typically interpreted very broadly. [222] Under the interest-or-expectancy test, Darling didn't have any interest or expectancy related to "flying" drugs,

nor was such a drug essential to Darling's business. As a result, Peter would probably win with the argument that the opportunity wasn't a "corporate" opportunity at all.

54. (a) That the company was financially unable to take advantage of the opportunity, and thus hasn't been harmed.

(b) Unclear. Courts are split about whether and when the corporation's financial inability to take advantage of the opportunity constitutes a defense to a usurpation-of-opportunity claim. Many courts say that unless the defendant made full disclosure of the opportunity to the corporation in advance, he may not later rely on its probable financial inability as a defense. [226] Courts following this view reason that: (1) if the opportunity is attractive enough, the corporation might be able to raise the funds even if it doesn't already have them on hand; and (2) allowing financial inability to be a defense furnishes a bad incentive to corporate insiders, because the defense's availability discourages the insider from seeking a way to help the corporation raise the funds. Since Peter didn't notify anyone associated with New England Potato about the opportunity before taking it for himself, he won't be able to raise the "financial inability" defense later, under this view.

But other courts, including Delaware, don't require advance disclosure as a pre-requisite to a "financial inability" defense. So in those states, Peter's failure to notify anyone at the company before taking the opportunity for himself won't bar his use of the financial-inability defense.

V. THE SALE OF CONTROL

A. Nature of problem: A "controlling block" of shares in a corporation will often be worth more, per share, than a non-controlling block. This fact raises the key question that we discuss in this section: May the controlling shareholder sell his block for a significantly ***higher price*** than that available to non-controlling shareholders who also wish to sell, and keep the excess for himself? In general, the answer is ***"yes,"*** but with some important exceptions.

1. **What is a "controlling block":** First, let's consider what is meant by a "controlling shareholder" or a "controlling block" of stock. A person has effective "control" (and his block is a "controlling block") if he has the ***"power to use the assets of a corporation as [he] chooses."*** S,S,B&W, p. 1138.

   a. **Not necessarily majority:** A person who holds a ***majority*** of the shares of the corporation necessarily has control. But even a ***minority*** interest may be controlling. For instance, the holder of a substantial minority interest (e.g., 30% or more) will usually have effective control if he holds the largest single interest, and the remaining interests are quite fragmented. The existence of a controlling interest is a factual question — a 20% interest might be controlling in one corporation (e.g., a large corporation where no one else owns more than 2%) but not controlling in another (e.g., where someone else holds a majority or a larger minority position).

2. **Why control might be worth a premium:** Why should a control block sell for a ***"premium"***? ("Premium" is the term used to describe the excess that an acquirer pays for the control shares over what he would pay for non-controlling shares.) The answer is that a person with control has the ***"keys to the corporate treasury"*** (S,S,B&W, p. 1139), and may for a variety of reasons attach economic value to those keys. Depending on how this power over the corporate treasury is used, the controlling shareholder may be acting properly or improperly; even a "proper" use of control, however, may have real economic value for an acquirer.

   a. **Change of strategy:** For example, consider Investor, a skilled business person who has been successful at buying troubled corporations and "turning them around" by changing their strategy. If Investor buys a non-controlling interest in Target, he will not be able to influence Target's strategy, and will therefore have to depend for return on his investment on Target's operations and management as these now exist. If, however, he can acquire a controlling interest in Target, he can change the management, sell off assets, pursue new lines

of business, or otherwise directly influence Target's future prospects. It would not be foolish for him to pay more, on a per-share basis, for a controlling interest than for a non-controlling interest in Target. (Observe that having Investor acquire a controlling interest in Target might well be advantageous to the non-controlling holders of Target; if Investor makes divestitures, starts new lines of business, etc., and thereby increases the value of the company, these minority holders benefit along with Investor.)

b. **Use for personal gain at expense of others:** On the other hand, one who acquires control may use the corporation for less laudable purposes, and in fact for purposes which leave the non-controlling shareholders ***worse off*** than they were before the acquisition. For instance, Investor may pay a premium to get a controlling interest in Target, then convert some of Target's assets to his ***own personal use***. He might do this in a direct bald-faced manner (e.g., by selling corporate property to himself at a very below-market price) or he might do it in a way that would be harder to attack (e.g., by paying lower dividends on all stock, and using the savings to pay himself an above-market salary as self-appointed president of the company).

c. **Summary:** In any event, whether the acquirer plans to use his control for proper or improper purposes, he would rationally pay more per share for control than for a non-controlling interest.

d. **Seller demands control premium:** Conversely, the existing holder of control will often be unwilling to ***sell*** his stock without getting a control premium, i.e., without getting some compensation that is not given pro rata to other shareholders. After all, he already has control, and is presumably drawing some of the advantages of control (e.g., a cushy salary as president, which he probably will lose if he sells) that the non-controlling shareholders don't have.

3. **Ways of arranging control premium:** Therefore, we have an

existing controlling shareholder and a would-be acquirer, each of whom has an incentive to arrange a transaction in which the controlling shareholder will receive a control premium. Buyers and sellers of control have shown almost limitless ingenuity in arranging ways to pay/receive extra for the control block.

Example 1: Buyer is willing to pay $1 million for the assets of Target, 60% of the shares of which are owned by Dominant. Instead of buying all shares for a total of $1 million (so that Dominant would get $600,000), Buyer buys just Dominant's shares, and pays $700,000 for them. Buyer now controls 60% of the stock. Buyer now causes Target to sell all of the assets to himself for $750,000. Buyer now liquidates the corporation, and receives back $450,000 (60% of $750,000). Buyer has paid the same $1 million net that he was always willing to pay for the assets ($700,000 to Dominant, $750,000 to Target, less $450,000 received back on liquidation of Target). Yet Dominant has received $100,000 more than he would have gotten by a pro rata sale, and the minority shareholders have gotten $100,000 less. See S,S,B&W, p. 998.

Example 2: Same facts as Example 1. However, Buyer merely buys Dominant's shares for $700,000, then continues to operate the business. The minority shareholders have no opportunity to sell, whereas Dominant has cashed out at an attractive price. Buyer may or may not operate the business in a way that benefits the minority shareholders, but clearly Dominant got an opportunity (to sell at a price valuing the whole company at $1 million) that the other holders have not gotten.

4. **General rule allows:** The general rule is that the controlling shareholder ***may sell his control block for a premium, and may keep the premium himself***. Clark, p. 478.

Example: The Ds and their families collectively own 44% of the stock of Gable Industries, Inc. The Ds sell their interests to Flintkote Co. for $15 per share at a time when

Gable stock is selling on the open market for a little more than $7 per share. P, a small shareholder, contends that the minority shareholders should be entitled to share in this control premium (apparently by having the Ds not sell all of their shares, and allowing the minority holders to sell part of theirs to Flintkote).

Held, for the Ds. "[A]bsent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price." The relief sought by P would require that a controlling interest could be transferred only by means of an offer to all stockholders, i.e., a tender offer. Such a radical change should only be done by the legislature, not the courts. *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387 (N.Y. 1979).

5. **ALI approach:** The ALI's *Prin. of Corp. Gov.* similarly recognize the general rule that a controlling shareholder may sell his control block for a premium (subject to various exceptions). See §5.16.

6. **Exceptions:** But as *Zetlin, supra,* hints, there are ***exceptions*** to the controlling shareholder's general right to sell his control block for a premium. The three main such exceptions are:

(1) the ***"looting"*** exception;

(2) the ***"sale of vote"*** exception; and

(2) the ***"diversion of collective opportunity"*** exception (which itself has two or three subbranches).

The remainder of our treatment of "sale of control" problems is devoted to these exceptions, which collectively have considerable importance.

B. The "looting" exception: Probably the most important exception to the general rule that a controlling shareholder may sell for (and keep) a premium, is the ***"looting"*** exception: "[A] holder of controlling shares may not knowingly, recklessly, or perhaps

negligently, sell his shares to one who intends to loot the corporation by unlawful activity." Clark, p. 479.

1. **Investment companies:** The clearest "looting" cases are those in which the corporation's principal or sole assets are stocks, bonds and other ***liquid*** assets. (Such companies are usually called ***"investment companies."***) The "true," i.e., net asset, value of shares in an investment company is usually readily calculated. Therefore, a controlling shareholder who sells his shares to a buyer who is willing to pay more than this net asset value has reason to be suspicious — the high price is almost impossible to understand if the buyer plans to run the company honestly, but very easy to understand if he plans to steal the corporate assets. Clark, p. 479.

2. **Close corporation:** Apart from cases involving investment companies, plaintiffs have only very rarely been able to show that the seller knew or should have known that the buyer intended to loot the company; therefore, there are very few non-investment-company cases in which the plaintiff has prevailed.

3. **Factors considered:** Here are some of the factors that courts have treated as ones that would arouse the suspicions of a reasonably prudent seller and thus trigger a duty to conduct further investigation: (1) the buyer's willingness to pay an ***excessive price*** for the shares; (2) the buyer's excessive interest in the ***liquid*** and ***readily saleable assets*** owned by the corporation; (3) the buyer's insistence on ***immediate possession*** of the liquid assets following the closing, and on immediate transfer of control by resignations of incumbent directors; and (4) the buyer's lack of interest in the details of how the corporation operates. Nutshell, pp. 363-64.

4. **Negligence theory:** Most courts seem to base liability on a theory of ***negligence***: the selling shareholder owes a duty of care to the corporation, and is liable if he breaches that duty by acting negligently (or, worse, recklessly or with malicious intent). Because of this negligence foundation, the courts often award ***damages*** equal to the ***harm*** suffered by the corporation. This

harm will often be greater than the "control premium" (the excess of price paid over a fair market value of the shares), and might conceivably even be greater than the entire purchase price — the seller could find himself not only paying back every dime he received, but then some!

C. The "sale of vote" exception: A second major exception to the general rule allowing the controlling stockholder to sell for a premium, is the so-called ***"sale of vote"*** exception.

1. General ban on sale of office: To begin with, understand that as a matter of public policy, courts prohibit the bald sale of a corporate office.

Example: Smith is a director of Corporation, and sits on its nominating committee (which nominates candidates to fill vacancies on the board). Without Smith's vote, the board is equally divided on many important matters of policy. Smith decides to resign, and goes to one of the competing factions. He says that in return for $10,000, he will not only resign, but use his influence with his co-directors on the nominating committee to cause a candidate favored by that faction to be nominated and elected to fill the vacancy.

Virtually every court would strike down this agreement (and the ensuing nomination and election of a director stemming from it) as violating the public policy against sale of a corporate office. Smith, as a director, owes Corporation a fiduciary obligation, which includes the obligation to nominate the candidate he thinks is best for Corporation, not the one whose election will most benefit Smith personally. Clark, p. 480.

2. Application to sale of control context: This rule against the "sale of office" has occasionally been applied to the sale-of-control context, so that the person selling control has to return his control premium to the corporation or the minority shareholders. An illegal sale of office is most likely to be found in two situations: (1) where the control block is much less than a majority of the shares, but the seller happens to have unusual

influence over the composition of the board; or (2) where the sale contract expressly provides for a separate, additional, payment if the seller delivers prompt control of the board.

3. **Small minority:** It may occasionally happen that a shareholder, even though he holds only a ***small minority*** of the shares, happens to have a large influence over a majority of the board of directors. If as part of this shareholder's sale of his shares, he causes this majority to resign and be replaced by directors controlled by the buyer, the court may find that the control premium amounts to a disguised sale of office, and will therefore force the seller to disgorge this control premium.

   a. **Sale of majority of stock:** On the other hand, where what is being sold is a ***majority*** block, courts never strike down a control premium on the "sale of vote" theory — they recognize that the buyer will eventually be able to control the board through the regular stockholder election process, so they see no reason to require him to wait to achieve control.

   b. **"Working control" block:** The sale-of-vote issue is hardest to resolve when what is being sold is something that is, at least arguably, ***"working control."*** Remember that this phrase refers to a block that is less than a majority but still large enough that, as a ***practical matter***, the possessor will ultimately be able to get his nominees elected to a majority of board seats (perhaps because there are no larger minority blocks and the remaining interests are very fragmented). For instance, a 20-40% block will often represent working control of a widely-held publicly traded company. One problem with analyzing such a situation is that there is no way to know in advance whether a substantial minority block will indeed turn out to be controlling in the buyer's hands — the buyer may expect that, say, a 25% block will give him control, yet discover to his chagrin that because of some unforeseen organized opposition, a competing tender offer, or some other reason, he does not get control. In this ambiguous situation, courts are split about whether the seller may legally charge and pocket a premium that depends in part on his delivery of

immediate resignations of some or a majority of the directors.

i. ***Essex Universal* case:** In the principal case on this subject, *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962), the two judges who discussed the issue (sitting together on the same panel) disagreed with each other. The block represented 28.3% of the stock, and the seller contracted to deliver to the buyer resignations of a majority of the directors and to cause the buyer's nominees to replace them. One judge believed that the court should presume that the 28.3% block would eventually confer control on the buyer, so that unless the plaintiff could show otherwise, the transaction should be allowed to stand. The other judge believed that (at least as a matter of policy though not as a matter of interpreting New York State law) the seller's agreement to deliver immediate control should be struck down unless it was "entirely plain that a new election would be a mere formality," which he thought was only true for cases involving the sale of a virtual majority, which 28% was obviously not.

4. **Separate payment for sale of control:** A second situation in which the sale of the control block may be found to be an "illegal sale of control" is if the sale contract provides for a ***separate payment*** to be paid only for, and upon, the delivery of directors' resignations and election of the buyers' nominees to the board. However, this is a pitfall that can be easily gotten around by careful drafting: the seller's lawyer must be careful that the contract states a single purchase price for stock and the resignations, rather than separate prices for each.

5. **Subsequent re-election as ratification:** Even where the court might otherwise order the seller to disgorge the control premium because he has in effect "sold his vote," the court may reach a contrary decision if the seller's nominees have been ***re-elected*** at a ***subsequent shareholders' meeting***. In this situation, the fact that the buyer's nominees have been re-elected by shareholder vote shows either that the buyer did have working control, or that the minority shareholders have not been damaged (since they

have ratified the buyer's choices for the board); in either event, there is no reason to confiscate the seller's control premium.

D. Diversion of collective opportunity: The final major category of exceptions to the general rule allowing a control premium has been called the ***"diversion of collective opportunity"*** (Clark, p. 482), a phrase which we use here. This phrase refers to situations in which for one reason or another the control premium should really be found to belong either to the corporation or to all shareholders pro rata. The two main situations in which courts have found such a diversion of collective opportunity are:

[1] where the court decides that the control premium really represents a ***business opportunity*** that the corporation could and should have pursued ***as a corporation***; and

[2] where a buyer ***initially tries*** to buy most or all of the corporation's ***assets*** (or to buy ***stock pro rata*** from all shareholders), and the controlling shareholder instead talks him into buying the controlling shareholder's block at a premium instead.

1. Displaced corporate-level business opportunity: The first of these sub-types of "diverted collective opportunity" is somewhat amorphous: the idea is that the corporation as such has a ***business opportunity*** that it would normally pursue on its own, but for some extraneous reason the value of this opportunity is instead "sold" to the buyer of a control block in return for a control premium. The best-known (and perhaps the only) case clearly illustrating this "displaced company-level opportunity" theory (see Clark, p. 482) is the landmark case of ***Perlman v. Feldmann***, 219 F.2d 173 (2d Cir. 1955). Because of this case's importance, we consider it in some detail:

a. Facts: Feldmann was the president and dominant shareholder of Newport Steel Corp. During the Korean War, the steel industry voluntarily refrained from increasing its prices, even though the war caused demand to skyrocket and shortages to develop. Wilport Co. was a syndicate of steel end-users who wanted to obtain more steel than they had been able to get.

Wilport bought Feldmann's controlling interest in Newport for a price of $20 per share (at a time when the publicly-traded shares of Newport were selling for $12 a share, and its book value per share was $17). Once Wilport gained control, it apparently caused Newport to sell substantial amounts of steel to Wilport's members, though such sales were always made at the same prices Newport charged its other customers. Non-controlling shareholders of Newport sued Feldmann, arguing that the control premium Feldmann had received for his shares was directly due to the premium buyers were willing to pay for steel in a time of shortage, and that this premium was therefore essentially a corporate asset that should belong to all shareholders pro rata.

i. **The Feldmann Plan:** The plaintiffs supported this assertion by pointing out that before the stock sale, Newport had been obtaining some extra benefit from the steel shortage by use of what was known as the "Feldmann Plan." Under the Plan, would-be customers would make interest-free advances in return for firm commitments to them of Newport's future steel production. Newport could then use these interest-free loans to build new plants, improve its existing plants, etc. In other words, use of the Feldmann Plan allowed Newport to in effect raise its prices (by obtaining interest-free loans in addition to the purchase price) without violating the industry's voluntary price guidelines. The plaintiffs apparently claimed (though this is not completely clear from the opinion) that after Wilport took control, it caused Newport to reduce or eliminate Feldmann Plan transactions, at least as to purchases made by Wilport's syndicate members.

b. **Holding:** The Court of Appeals agreed with the plaintiffs that by selling his control block for a premium, Feldmann had ***violated his fiduciary duty to the other share-holders.*** The court made it clear that it was not imposing any general rule that sale of a control block for a premium was a violation of fiduciary obligations. But when there was an opportunity for

corporate-level gain, and instead the controlling shareholder appropriated that gain for himself, there was a breach of such obligations — Newport could have continued to realize its extra profits by maintaining and even expanding the Feldmann Plan; instead, this corporate opportunity was (apparently) transformed into abolition of the Feldmann Plan and dollars into Feldmann's own pocket.

c. **Remedy:** The court took the further unusual step of ordering that any recovery (the amount of the premium) be paid ***solely to the minority stockholders***, not to the corporation. That way, Wilport (now the owner of Feldmann's shares) would not get any benefit from the recovery.

d. **Dissent:** Judge Swan wrote a well-known dissent. He contended that the usual rule (that a controlling shareholder may sell for a premium and keep it) should be applied so long as there was no evidence that the sale of control, or the buyer's subsequent actions, injured the corporation or the minority holders. Here, he found no such evidence — he stressed that Wilport syndicate members paid the same price for Newport steel as any other customer did. (He conveniently ignored the apparent fact that Wilport caused Newport to eliminate the Feldmann Plan, thus effectively lowering prices charged to *all* buyers of Newport steel.)

e. **Significance:** The significance of *Perlman v. Feldmann* is fairly ***narrow***: if the corporation has an ***unusual business opportunity*** that it is ***not completely taking advantage of*** (e.g., the ability to raise prices, to obtain interest-free loans, or otherwise to prosper in a time of great demand for its products), this opportunity ***may not be appropriated by the controlling shareholder*** in the form of a ***premium for the sale of control.***

2. **Seller switches type of deal:** If the buyer proposes to buy the entire company, but the seller instead ***switches*** the nature of the deal by talking the buyer into buying just the seller's control block (at a premium), a court may take away the seller's right to

keep the premium, on the grounds that all shareholders deserve the right to participate.

E. ALI approach: The ALI's Prin. of Corp. Gov. don't recognize the above three exceptions as such. Instead, the ALI approach sets out two more general exceptions to the general rule that the control block may be sold for a premium:

❑ The controlling shareholder may not fail to ***make disclosure*** to the other shareholders with whom he deals in connection with the transaction.

> **Example:** *A*, the 52% shareholder of Corp., agrees to sell his block to Acquirer at an above-market price. Simultaneously, as part of his arrangement with Acquirer, *A* recommends to the minority holders that they sell to Acquirer at the market price. *A* doesn't tell the minority holders that he's selling at a higher price. The *ALI Prin. of Corp. Gov.* say that *A* has violated his "duty of fair dealing" to the minority holders. See Illustr. 4 to §5.16.

❑ The controlling shareholder may not sell his control block if "it is apparent from the circumstances that the ***purchaser is likely to violate the duty of fair dealing*** …in such a way as to obtain a significant financial benefit for the purchaser or an associate."

> **Example:** This covers the "looting" situation: if it should be apparent to the controlling holder that the purchaser will sell corporate assets to himself at a below-market price, or sell property to the corporation at an above-market price, the controlling shareholder can't carry out the transaction (even at a market price).

F. Remedies: As we've said above, in a normal situation the controlling shareholder may sell for, and keep, the control premium. But in those special situations where the general rule does not apply (sale to looter, sale of office, diversion of collective opportunity), what exactly is the ***remedy*** that the plaintiff who succeeds on the merits will receive? The two basic possibilities are: (1) return of the premium to the corporation; and (2) payment of

some portion of the premium directly to the non-controlling shareholders.

1. **Recovery by corporation:** For these three theories of recovery — sale to looter, sale of office and diversion of collective opportunity — the most logical form of recovery is ***by the corporation***. At least arguably, it is the corporation's assets that have been sold to produce the control premium, so it is the corporation that should get the premium back. This is indeed how some cases have been decided.

2. **Benefits purchaser:** But there is a big problem with having the control premium returned to the corporation: this remedy gives the ***purchaser*** — the very person who agreed to pay the control premium — an unanticipated and probably undeserved windfall. For instance, if Dominant owns 50% of Target, and sells that stake to Buyer for a $10 per share premium, if the premium is ordered returned to Target then half of it will effectively end up in Buyer's pocket (since he now owns 50% of Target's shares). Therefore, the court may decide to order the seller to repay ***directly to the minority shareholders*** their pro rata part of the control premium.

   a. ***Perlman v. Feldmann:*** This is exactly what happened on remand in *Perlman v. Feldmann*, *supra*, p. 238. The district court concluded that the premium had been $5.33 a share, or $2,126,280. The non-controlling minority shareholders owned 63% of the stock. Therefore, the court ordered that the selling controlling holder pay them $1,339,769 (63% of $2,126,280). See *Perlman v. Feldmann*, 154 F.Supp. 436 (D. Conn. 1957). This method allowed Feldmann to keep his pro rata share of the control premium, and prevented the buyers from getting back any of the benefit from the control premium they had paid.

Quiz Yourself on
***THE DUTY OF LOYALTY** (THE SALE OF CONTROL)*

55. Abner Doubleday is a 55% shareholder of the NASDAQ-listed Splendid Splinter Baseball Bat Company, Inc. The fair market value of Splendid Splinter's stock on NASDAQ is $20. Doubleday decides he wants to give up the bat business and go into something really lucrative — forging sports memorabilia. Scuff Spitballer, a reputable businessman, offers to buy Doubleday's shares for $30 each, if he's willing to sell all of them. Doubleday accepts the offer. Splendid Splinter's minority shareholders sue Doubleday on behalf of Splendid Splinter, seeking the $10 premium he received for his shares over fair market value. Who wins?

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56. Ali Baba Art Galleries, Inc., buys and sells fabulously expensive works of art. Ali Baba, controlling shareholder of the galleries, sells his shares to Scheherezade, at a price $20 a share above market value. Scheherezade immediately begins to sell to herself the Galleries's inventory of art works at grossly understated prices. By the time minority shareholders wake up and sue Scheherezade, she has secreted the works (apparently in the vaults of an unidentified Swiss bank), and is thus effectively judgment-proof.

(a) You represent one of the minority holders. On what theory might you sue Ali Baba for the difference between the true value of the artworks sold by Scheherezade to herself and the price she paid?

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(b) State the factors (not necessarily ones presented explicitly in the above statement of facts) that, if proved at trial, would support your theory of recovery. ______________________________

57. The Sleeping Beauty Sewing Machine Company has seven directors. Its shares are publicly traded, with a price hovering around $10 a share. Evil Stepmother decides she wants to acquire control of the company. Evil Stepmother approaches five of the directors — Grumpy, Dopey, Sleepy, Bashful, and Doc — and asks them to sign a document in which they agree that they will (1) immediately resign and (2) as a final act on the board, vote for Evil's nominees as their successors as directors. The document also states that Evil will pay each director $20 a share for his shares. The five directors together own about 7% of the company's stock. (The President owns about 25% of the stock, and the rest is held by the

public at large.) The directors sign the agreement, then resign and vote as they've agreed to do.

(a) What is the best theory under which a minority holder in the company could sue the 5 resigning directors?

____

(b) Will that theory succeed? ____________________________

Answers

55. Doubleday. The issue here is whether a controlling shareholder can sell his control at a premium — that is, a price above the fair market value of the shares. The *general* rule is that he may, in fact, sell his shares for whatever price he wants. [234] There are exceptions to this doctrine, but none of the exceptions applies here. (For instance, Doubleday has no reason to believe that the buyer will loot or otherwise harm the corporation, Doubleday hasn't explicitly agreed to transfer control of the board as a condition of the deal, and there's no reason to believe that the premium is a diversion of a "collective opportunity.") So Doubleday is within his rights in collecting something extra for his controlling stake, even though he's getting a benefit not available to other shareholders.

56. (a) That Ali Baba knew or should have known that Scheherezade was likely to "loot" the company.

Part of a controlling shareholder's fiduciary duty to his corporation is that he cannot sell control to anyone whom he knows or should know will harm the company (e.g., by looting the company's treasury, committing fraud on the corporation after acquiring control, or implementing business policies that would harm the corporation or its shareholders). [235]

(b) Any facts that ought to have put Ali on notice of Scheherezade's intent-to-loot would be helpful.

Look for pre-transaction facts known to Ali, such as Scheherezade's exaggerated interest in the corporation's liquid assets; any demand by her that control be transferred to her immediately following the closing; any sign that she had only a negligible interest in the corporation's operations; or evidence that as Ali knew, Scheherezade had engaged in similar self-

dealing with corporations she'd bought in the past. [235] (Her mere payment of a substantial premium for control, by contrast, would be only a *weak* indication that she might intend to loot the corporation.)

57. **(a) That the document constituted an illegal "sale of office."** A director or group of directors, like any other shareholder, can normally sell for a "control premium." However, a director cannot baldly sell "his office," i.e., his directorship. [236]

(b) Yes, probably. Since the 7% stake bought by Evil would not normally have given her control of the board, and since the purchase agreement here was expressly contingent on the sellers' resignations and votes for Evil's board nominees, it's hard to imagine a more blatant sale of a directorship. So the court will probably order the selling directors to disgorge the control premium either to the corporation or (preferably) directly to the shareholders other than Evil. (If the 5 selling directors owned, and were selling, a *majority* of the shares, then probably no sale-of-office would be found; that's because Evil would have been able to get control of the board eventually, even without the resignations and succession votes by the sellers. The same would probably be true if the selling directors were selling Evil a "working majority." [236])

VI. OTHER DUTIES OF CONTROLLING SHAREHOLDERS

A. Introduction: So far in this chapter, we have looked at various contexts in which controlling shareholders, like directors and executives, have a duty of loyalty to the corporation. We now focus on a collection of miscellaneous contexts in which controlling shareholders, in particular, may have a special duty of loyalty to their fellow non-controlling shareholders. Of these special contexts, the most important is that involving a parent-subsidiary relationship — a parent that does not own all the stock of the subsidiary is generally held to have a fiduciary obligation to the subsidiary's minority shareholders. This topic is discussed beginning *infra*, p. 243.

B. Possible general fiduciary duty: Does a controlling shareholder have any kind of ***general fiduciary duty*** to his fellow non-controlling shareholders?

1. **Not covered by statute:** Few if any states impose such a general fiduciary duty on the controlling shareholder by ***statute***. For instance, the MBCA is completely silent about the general fiduciary obligations (if any) owed by controlling shareholders. (Of course, if the controlling shareholder is also a director or executive, there are likely to be statutory duty-of-loyalty obligations explicitly imposed on him, such as MBCA §8.31's rules on self-dealing transactions involving directors. But the point I am making here is that few if any statutes impose fiduciary obligations on a shareholder *qua* shareholder.) Therefore, any fiduciary obligations must be imposed as a matter of ***case law***.

2. **Close corporation situation:** In the case of a ***close corporation***, some courts have expressly concluded that the controlling shareholder has a significant fiduciary obligation to his fellow shareholders. See, e.g., the landmark case of *Donahue v. Rodd Electrotype Co*, *supra*, p. 161. Thus Massachusetts (the state where *Donahue* was decided) as a matter of case law prevents a controlling shareholder in a close corporation from putting his own interests ahead of those of his fellow shareholders. For instance, the controlling shareholder may not cause the corporation to redeem some of his own shares at an attractive price, without also causing the corporation to offer a similar redemption arrangement to the minority shareholders. *Donahue*, *supra*.

3. **Public corporations:** Where the corporation is ***publicly held***, the courts have been less quick to impose on the controlling shareholder a fiduciary obligation with any real bite. The fact that a controlling shareholder is generally allowed to sell his controlling interest at a premium (*supra*, p. 234) is one illustration of this lack of any generally-recognized fiduciary obligation to one's non-controlling co-shareholders.

a. **Possible duty of complete disclosure:** However, even in the public-company context, when a controlling shareholder or group deals with the non-controlling shareholders some courts say the controller owes the non-controllers a ***duty of disclosure*** (not a duty to behave with substantive fairness) with respect to the transaction, as a matter of state common law.

Example: Controlling shareholders in ABC give notice of the proposed buyback of a minority block of stock, without telling the minority holders that due to secret developments the minority holders would benefit by exercising certain conversion rights. A court might well hold that this failure to give complete disclosure violated the majority's common-law obligation to the minority. See, e.g., *Zahn v. Tansamerica Corp.*, 162 F.2d 36 (3d Cir. 1947), so holding.

C. **Parent/subsidiary relations:** Most cases involving the duties of a controlling shareholder to the non-controlling holders arise in the context of the relationship between a parent and its ***not-wholly-owned subsidiary***. In general, these parent/subsidiary cases are analyzed the same way as any other case involving the duties of a controlling shareholder to the non-controlling holders. Thus some courts say that the parent has a fiduciary obligation to the other shareholders in the subsidiary, but it is not clear how much bite this obligation has. We must look at different contexts (e.g., merger, dividends, parent-subsidiary contracts, etc.) to get a meaningful view of what the parent's obligations are, since these vary depending on the context.

1. **Merger:** It will often be the case that the parent wants to turn the subsidiary into a ***wholly-owned*** subsidiary, by ***buying out*** the minority shareholders and then merging the subsidiary into the parent. In these transactions, the general rule is that the merger must be at a ***fair price***. The main legal issues are: What price is fair? and How should the determination of fairness be made? This topic is discussed extensively beginning *infra*, p. 411; see especially the treatment of *Weinberger v. UOP*, *infra*, p. 425.

2. **Dividends:** The parent, by virtue of its controlling interest in the subsidiary, will be able to control or at least influence the subsidiary's ***dividend policy***. The minority holders may not like this dividend policy: they may feel that the dividend is too high (and the cash should instead be reinvested in the subsidiary's business rather than being paid out pro rata to the parent and to the minority holders); or, they may feel that the dividend is too low (and should be paid out rather than re-invested in the subsidiary's business). The minority holders can plausibly argue that when the parent sets the subsidiary's dividend policy, the parent is engaged in a self-dealing transaction (defined *supra*, p. 198), and that the policy should therefore be closely scrutinized by the court.

   a. **Unsuccessful argument:** However, the minority holders in this parent/subsidiary situation have generally been ***unsuccessful*** at getting the courts to apply the self-dealing rules to dividend transactions. Courts generally are swayed by the fact that the dividends are paid ***pro rata*** to all shareholders, so the parent isn't getting any more money ***per share*** than are the minority holders. Courts that take this view ignore the fact that different shareholders have different preferences, and the fact that a given dividend policy that is good for the parent may be bad for other shareholders. In any event, the general rule seems to be: even though the parent may be controlling the subsidiary's dividend policy, so long as that policy satisfies the ***business judgment rule*** (i.e., it isset in good faith after reasonable investigation, and is not completely irrational;[1] see *supra*, p. 182), it will be ***upheld*** by the court.

      Example: Sinclair Oil ("Sinclair") owns 97% of the stock of Sinclair Venezuelan Co. ("Sinven"). Sinclair controls the board of directors of Sinven. Sinclair causes Sinven to pay out extremely high dividends (in fact, dividends in excess of Sinven's earnings) during a 7-year period. The Ps (who are among the 3% minority stockholders in Sinven) sue Sinclair, arguing that this dividend policy violates Sinclair's fiduciary duty to Sinven.

Held, for D (at least on this point). The dividends were paid in proportion to stockholdings, so that Ps got their aliquot share (3%) of all dividends paid. Therefore, the setting of the dividend policy was not self-dealing by Sinclair. Instead, the policy must be judged by the business judgment rule. Since the Ps cannot show that the dividends resulted from "improper motives and amounted to waste," the business judgment rule is satisfied and the dividend policy must be upheld. (Other aspects of the case are discussed *infra*, p. 244). *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

3. **Self-dealing between parent and subsidiary:** As *Sinclair* indicates, the fact that Parent has set Subsidiary's dividend policy does not constitute self-dealing. But other types of transactions between Parent and Subsidiary may well be found to be self-dealing. If so, these transactions are judged by the same rules applied to self-dealing transactions outside of the parent/subsidiary context. (See *supra*, p. 200, for an explanation of these rules.) In general, the minority holders in Subsidiary can therefore get a self-dealing transaction struck down if they can show that it was ***not fair*** to Subsidiary and that it was not approved by either ***disinterested*** directors or disinterested shareholders.

   a. **Dominated board:** In the common situation where Parent dominates the entire board of Subsidiary, this means that unless the ***minority shareholders*** have been given a chance to ***ratify*** the self-dealing transaction, they can have the court strike down the transaction if it is not fair to them. In fact, once the minority holders of Subsidiary show that there has been self-dealing by Parent with respect to Subsidiary, the ***burden of proof shifts*** to Parent: Parent must now ***show affirmatively*** that the transaction was ***fair*** to Subsidiary.

      Example: Go back to the facts of *Sinclair*, *supra*. Sinclair and Sinven make a contract in which Sinven agrees to sell all of its crude oil and refined products to Sinclair at specified prices, payment to be made on receipt. The

contract includes minimum and maximum quantities. Sinclair breaches the contract in several respects (e.g., it does not pay on receipt, and it does not order the contractually-specified minimums). The Ps (minority shareholders in Sinven) claim that the contract constituted self-dealing, and that it should be struck down unless Sinclair shows that the contract was fair.

Held, for the Ps. "Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary." Here, the contract meant that Sinclair was taking Sinven's oil for itself, rather than allowing the oil to be sold on the open market. Therefore, the contract was self-dealing. Such a self-dealing contract will only be upheld if the parent satisfies the "intrinsic fairness" standard. Here, Sinclair did not bear the burden of showing why Sinven's failure to enforce the contract against Sinclair was "intrinsically fair" to the minority shareholders of Sinven. Therefore, Sinclair is liable to the minority holders for their share of the damages that Sinven could have obtained for breach. *Sinclair Oil Corp. v. Levien*, *supra*, p. 244.

b. Other kinds of contracts: *Sinclair* was a very clear example of self-dealing (even though the level of unfairness to the minority holders was apparently not great): Parent was buying all of Subsidiary's output. But courts have also found self-dealing — and struck it down on grounds of unfairness — where the presence of Parent on both sides of the transaction with Subsidiary was much more subtle. For instance, the court may hold that Parent's provision of legal, accounting, financial or other general ***corporate services*** to Subsidiary amounts to self-dealing, and must be struck down if unfair.

4. Acquisitions and other corporate opportunities: Recall that the doctrine of ***"corporate opportunity"*** prevents a Key Player from usurping for himself an opportunity that is found properly

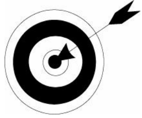
to “belong” to the corporation. This corporate opportunity doctrine may apply in the parent/subsidiary context: If Parent takes for itself an opportunity (e.g., an ***acquisition***) that the court finds really belongs to Subsidiary, the minority holders of Subsidiary will be able to reclaim that opportunity for Subsidiary, or at least recover damages.

a. Standard: In general, courts have applied the same corporate opportunity doctrine in the parent/subsidiary context as they do in the ordinary non-subsidiary situation. See Clark, p. 256. For instance, if the court would apply a multi-factor test like Delaware’s (p. 221) to a transaction in which President takes for himself a business opportunity that might have been taken by Corporation, the court would presumably also apply this multi-factor test to determine whether an opportunity taken by Parent belongs to Subsidiary.

5. Disinterested directors: Both for self-dealing transactions and for corporate opportunities, Parent may avoid claims of unfairness by Subsidiary’s minority shareholders if Parent somehow (perhaps temporarily) “undoes” its domination of Subsidiary. For instance, if Subsidiary has some truly ***disinterested directors*** (e.g., directors elected by the minority shareholders), Parent could let these disinterested directors ***negotiate on behalf of Subsidiary.*** This would help immunize any contract between Parent and Subsidiary against a claim of self-dealing, and would permit Subsidiary to pursue any business opportunity on its own that was also being pursued by Parent.

a. Mergers: In the case of a proposed ***merger*** of Subsidiary into Parent (and consequent forced buyout of the minority shareholders of Subsidiary), having Subsidiary represented by such an independent committee of directors is now the normal way of proceeding. See *infra*, p. 426.

Exam Tips *on*



THE DUTY OF LOYALTY

The duty of loyalty is the single most frequently-tested subject on exams. Duty of loyalty issues often appear in the same fact patterns as duty of care issues. Watch particularly for ***self-dealing transactions*** (transactions in which a director has a ***financial interest***) and situations in which a director or senior exec. takes personal advantage of an ***opportunity*** which might ***belong to the corporation.***

☛ ***Self-dealing transactions*** are usually easy to spot. Look for situations in which the corp. has ***conducted business*** with a director or senior exec. ("Key Player"), or with a member of a Key Player's family.

Once you spot a self-dealing transaction, remember that you have to do a ***multi-step analysis*** to determine whether it's a breach of the duty of loyalty:

Step 1: Did the Key Player ***disclose*** the conflict and the nature of the transaction ***in advance*** to either senior management or the entire board (whichever would normally be expected to make the decision for the corp. on whether to do the transaction)? If "yes," go to Step 2. If "no," got to Step 3.

Step 2: [For advance disclosure situations]: Did a majority of the ***"disinterested directors"*** (or a ***"disinterested superior"*** if the Key Player is not a director) ***approve*** the transaction? If "yes," there was ***no breach*** of the duty of loyalty. If "no," go to Step 3.

Step 3: [For situations where there was no advance-disclosure-plus-approval]: Did the Key Player ***disclose*** the conflict and nature of the transaction ***after*** it was entered into (either before suit or within a reasonable time after suit was filed), to either senior management or the board (as appropriate — see Step 1)? If "yes," go to Step 4. If "no," go to Step 5.

Step 4: [For after-the-fact disclosure situations]: Did a majority of the ***"disinterested directors"*** (or a "disinterested superior" if the Key Player is not a director) ***ratify*** the transaction? If "yes," there was no breach of the duty of loyalty. If "no," go to Step 5.

Step 5: [For situations where the board never gave proper approval or ratification]: Did a majority of ***disinterested shareholders***, following disclosure of the conflict and the transaction, either ***approve it*** in advance or ***ratify it*** afterwards? If "yes," go to Step 6. If "no," go to Step 7.

Step 6: [For situations where the disinterested s/h's approved]: Was the transaction a ***"waste"*** of corporate assets, viewed as of the time of s/h approval or ratification? If "no," there was ***no breach*** of duty of loyalty. If "yes," it ***is a breach*** of the duty of loyalty.

Step 7: [For sits. where there is neither board nor s/h approval or ratif.]: Was the transaction ***"fair"*** to the corp. when entered into? If "yes," there is no breach of duty of loyalty.

If "no," there is a ***breach*** of loyalty.

Example: Pres, the president of A Corp., negotiates an agreement for A Corp. to buy all of Y Corp's outstanding shares. Only one of A's 6 other directors is told by Pres. that Pres's immediate family holds all of Y Corp's shares. The board approves the transaction. Y Corp. proves to have little value. A minority s/h brings a derivative action against Pres. for damages from the purchase. You should say that since there was never disclosure of the conflict to all the independent directors [Steps 1 and 3 above], and since there was no shareholder approval [Step 5], the court will strike down the transaction unless it believes that the transaction was "fair" to the corporation [Step 7].

Other examples of self-dealing: (1) Pres. negotiates to have all of Corp's properties cleaned by X Co., and doesn't disclose that he has a large ownership interest in X Co. (2) B, a director of Corp., conveys equipment worth $50K to Corp. in return for $100K of stock, without disclosing that the equipment is only worth $50K (and while knowing that most directors think it's worth $100K).

- ☞ Always remember that ***pre-approval*** (after disclosure) by a majority of the ***disinterested directors*** or a majority of ***disinterested shareholders*** will ***immunize*** the transaction, and a court will not even consider whether the transaction is "fair." (See Steps 2 and 5.)
- ☞ Also, post-transaction ***disinterested-shareholder ratification*** of the

transaction, made after disclosure and before suit, will always ***immunize*** the transaction (Step 5), and post-transaction disinterested-***director*** ratification will usually immunize it (Steps 3-4).

☞ Remember that if the facts suggest to you that the transaction was ***"fair"*** (i.e., not disadvantageous) to the corp., ***viewed as of the time it was made***, it won't be set aside or serve as the basis for damages, even if there was no disclosure, no independent-director approval and no shareholder approval. That is, fairness puts a ***complete end*** to the inquiry.

☛ Whenever a fact pattern indicates that a Key Player has taken personal advantage of an opportunity, consider whether the doctrine of ***corporate opportunity*** applies. Remember that this doctrine prohibits a Key Player from taking advantage of an opportunity which belongs to the corp., unless he first ***discloses*** the offer to the other directors or to senior management.

☞ Here are some factors which strengthen the inference that an opportunity is a corporate one:

❏ The Key Player ***learned*** of the opportunity while acting in his role as the ***corp's agent*** rather than as an individual;

❏ The opportunity is ***closely related*** to the corp's ***existing or prospective activities***;

❏ The opportunity is ***essential*** to the corp's ***well-being***; or

❏ The corp. had (and the Key Player knew that the corp. had) a ***reasonable expectation*** that the opportunity would be regarded as a corporate one.

Example: At a board meeting of A Corp., B, a director of the corp., learns that the corp. is planning on expanding, and that it's examining 3 parcels adjacent to one of its existing plants. B pays $3,000 for an option to buy one of those parcels for $120,000, and does not tell his fellow directors before doing this. B has probably usurped a corp. opportunity, since he learned of the parcel's availability from his work for the corp., the parcel is closely related to the corp's prospective activities (expansion), and the corp. reasonably expected

that any parcels considered during the board meeting would be viewed as corporate opportunities. Therefore, B can probably be required to turn over the option to the corp.

- ☞ It generally takes less of a conflict for the corp. opportunity doctr. to apply when the Key Player is a ***full-time employee*** than where she is an ***outside director***.

- ☞ If the corp. opport. doctr. otherwise seems to apply, check whether the fact pattern contains signs that the corp. ***wouldn't have been able to take advantage*** of the opportunity even had it known of the opportunity. Say that courts are ***split*** about whether corporate inability (e.g., ***lack of financial resources***) can be a defense.

☛ Be alert for duty-of-loyalty issues where the fact pattern involves ***executive compensation***. Make sure that the corp. is receiving some benefit as a result of the compensation scheme — if it's not, it's likely to be invalid as a ***"waste"*** of corporate assets.

- ☞ If a compensation arrangement is ***approved in advance*** by ***disinterested directors or disinterested s/h's***, this pretty much ***immunizes*** it from s/h attack, even if a court might otherwise believe the compensation is ***"excessive."*** (Courts are split as to whether this is true even where the person receiving the compensation is a ***senior executive*** who has ***participated in the process*** by which the compensation was set.)

- ☞ ***Stock options*** are ordinarily acceptable, provided they do not result in clearly excessive compensation.

- ☞ ***Retirement benefits*** may pose a problem, especially if they are awarded at the ***moment of retirement,*** without being part of a general or pre-existing plan. Here, a s/h could claim that this is waste (or without consideration), because the corp. isn't getting anything in return. (*Example:* At the moment when Bill, a senior manager at A Corp., says he's retiring, Prexy [pres. of A Corp.] makes a written promise to pay Bill a $4,000/mo. pension for life. A Corp. does not have any general pension plan. A s/h might successfully attack this promise as being waste and without consideration, in which case the court may order the promise not to be enforced.)

- ☛ Sometimes you'll have a problem of ***interlocking directors*** (X is a director of two corps who do business with each other). Here, say that the duty-of-loyalty problems are typically ***not as severe*** as where a director deals for himself: unless the director's ***own financial interest is substantially at stake***, the fact that he sits on both boards won't create a conflict when the two corps do a transaction together (as long as there's disclosure of the fact that the director sits on both boards).

  Example: X is a director of both A Corp. and B Corp., and each corp. knows this. At a B Corp. meeting, X votes to have B Corp. buy certain property from A Corp. Unless X's financial stake in A Corp. (and the size of the transaction) are enough to give X a significant financial incentive to have B Corp buy the property, X's voting for the transaction is ***not*** a breach of his duty of loyalty to B.

- ☛ Keep in mind that a ***controlling s/h*** may (it's not clear) have an obligation to behave in a ***fiduciary manner*** towards minority holders. This principle is most likely to be applied if the majority tries to ***"freeze out"*** the minority. Be especially alert to freeze-out and other mistreatment-of-minority problems if the corp. is a ***closely-held*** one.

  Example: A, B, C, and D each own 25% of Corp. Corp. has always paid generous dividends to each s/h, since Corp's own operations don't need much capital. A, B, and C learn that D is desperately in need of cash, and is counting on continuation of the dividend stream. The 3 vote to suspend dividends for the sole reason of pressuring D, so that they can induce him to sell his stock back to Corp. cheaply. This is probably a violation of the duty of loyalty, since A, B and C have served their own interests rather than the interests of all holders.

- ☛ Even if you conclude that there's been a breach of the duty of loyalty, be sure to check that the corp. has suffered an ***actual loss*** — if there's no actual loss, then there can't be any recovery.

1. Courts seem to ignore the third requirement for the business judgment rule, that the decision-maker not be ***"interested"*** in the decision. Thus even though it's the parent or its employees and directors, not independent directors of the subsidiary, who set the dividend policy, the policy will get the benefit of the business judgment rule if it's set in good faith, after reasonable investigation, and in a not-completely-irrational way.

CHAPTER 8

INSIDER TRADING (AND RELATED TOPICS)

ChapterScope

This Chapter mainly discusses the rules that prohibit corporate insiders from trading in their corporation's publicly-held stock while in the possession of non-public information. Key concepts:

- **Definition:** Most commonly, insider trading occurs when a corporate "insider" (generally an employee or director of the corporation whose shares are being traded) buys or sells the corporation's stock, at a time when he knows material non-public information about the company's prospects.
- **State laws:** State law provides very little protection against insider trading.
- **10b-5:** Federal law prohibits insider trading. The main federal prohibition comes from SEC Rule ***10b-5***.
  - **Private right of action:** A person who has been harmed by an insider's trading (e.g., a non-insider who sold stock while the insider was buying) has the right to bring a ***private civil suit*** against the insider for damages.
  - **"Insider," "tippee" or "misappropriator":** A person isn't liable for insider trading unless he is either an ***"insider,"*** a ***"tippee,"*** or a ***"misappropriator."*** An "insider" is one who learned the information either as an employee or director of the corporation whose stock is being traded (true insider) or as one who was performing services for the corporation, such as a lawyer or accountant (constructive insider). A "tippee" is one who learned the information from an insider. A "misappropriator" is one who learned the information from one other than the issuing corporation, and breached a confidence by trading on the information.
- **Short-swing trading profits:** Entirely apart from true "insider trading," §16(b) of the Securities Exchange Act says that the profit from any

purchase-and-sale or sale-and-purchase of a public company's stock within 6 months by an officer, director or 10%-shareholder must be repaid to the corporation. This is the ban on "short-swing trading profits." This rule applies even if the insider does not in fact have any non-public information at the time he trades.

I. INTRODUCTION TO INSIDER TRADING

A. Definition of insider trading: As the term is used in everyday discourse, a person engages in "insider trading" if he ***buys or sells stock in a publicly-traded company based on material non-public information about that company***. Clark, p. 264. This very broad definition is the one we will have in mind when we use the phrase "insider trading" in this book.

1. Not all kinds illegal: You might think that all kinds of insider trading (as we've just defined it) are illegal under federal or state law principles. But interestingly, this is not so.

a. Illustration: For instance, suppose that Jones is sitting by himself in a restaurant and happens to overhear Smith tell his dining companion at the next table, "I just heard that we brought in a huge new well off the coast of Saudi Arabia." Jones happens to know that Smith and his companion both work for Oilco, a major oil company. Jones can buy stock in Oilco with impunity, even though he is acting on material non-public information. (See the discussion of *Chiarella v. U.S.*, *infra*, p. 274, and our discussion of the limits of SEC Rule 10b-5 *infra*, p. 267.) In general, the federal securities laws (which are the most important laws in this area) bar only that insider trading that occurs as the result of someone's willful breach of a ***fiduciary duty***, and no one in our Jones-Smith example has committed such a breach.

b. Broad meaning: In any event, when we use the phrase "insider trading," we'll be using this broad "not-necessarily-illegal trading based on non-public information" sense of the term, and much of our discussion will be devoted to exactly

when such trading is and is not illegal.

2. **Buying before disclosure of good news:** The paradigmatic example of insider trading (and in fact, insider trading of the clearly illegal variety) occurs when a high company official learns of some ***favorable development*** concerning his company, and buys stock in the company before this good news is disclosed to the public.

   Example: Prexy is the president of Oil Co., whose business is exploring for and then drilling for oil. Oil Co.'s stock is publicly traded, and investors interested in the company know that for some time, Oil Co. has been exploring a tract of remote Canada thought by most geologists to be unpromising. On July 1, Prexy learns that his exploration team has just struck what seems to be a substantial gusher at North Fork, Canada. He orders the team to keep silent about what they have found, and immediately purchases 10,000 shares of Oil Co. stock on the New York Stock Exchange at $20 a share. On July 2, he authorizes the company's public relations department to issue a press release stating "Major Gusher found by Oil Co. at North Fork." The stock immediately jumps to $30 a share. Prexy sells out the 10,000 shares, and pockets a profit of $100,000. (These facts are loosely adapted from *SEC v. Texas Gulf Sulphur Co.*, *infra*, p. 265.) Not only has Prexy traded on material non-public information, but his trading is of the clearly illegal variety, and he will face both criminal and civil liability under the federal securities laws.

3. **Selling on bad news:** Insider trading may also take the form of selling before the disclosure of ***bad news*** about the company's prospects.

   Example: Same facts as the prior example, except assume that on July 2, Prexy decides to hold onto his shares instead of selling them following the disclosure of the gusher. Then, on July 5, the gusher suddenly peters out, indicating that there was vastly less oil than the company (and the public) had thought. Before this news is disclosed to the public, Prexy

now sells his 10,000 shares (plus another 5,000 he had bought long before) at $30 a share. The bad news is then disclosed to the public, and the stock sinks all the way back to $20 a share. Prexy has made a "profit" by this insider selling (in the sense that he has avoided a loss) of $150,000. His insider selling here is just as illegal as his purchases in the prior example, and he will be both civilly and criminally liable under the federal securities laws.

B. The Efficient Capital Markets Hypothesis: Before we delve into the harms (and possible benefits) from insider trading, we must understand an economic doctrine that has become very central to the way courts and commentators analyze insider trading problems. This is the so-called Efficient Capital Markets Hypothesis (ECMH). Essentially, the ECMH says that ***security prices at all times fully reflect available information***. See S,S,B&W, p. 899. In other words, the ECMH says that if on a particular day a share of IBM stock is selling for $126, then the $126 figure reflects everything that is now known about IBM's business prospects, and is therefore the true "value" of that share.

1. Three forms: Actually, there are three forms of the ECMH, which make progressively more broad-sweeping claims about the extent to which prices reflect available information:

a. Weak form: The ***"weak form"*** of the ECMH states that "prices fully reflect all information contained in the ***historical pattern*** of market prices." Cox, quoted in S,S,&B, p. 901. In other words, this form says that an investor cannot, merely by looking at the pattern of past prices of a particular stock (or, for that matter, past prices of the stock market as a whole), predict the course of future prices. To put it another way, according to the weak form of the ECMH ***stock price movements are random***. For instance, the mere fact that IBM stock has gone up three days in a row does not increase, at all, the likelihood that it will go up on the fourth day. This weak form of the ECMH is ***very well accepted*** by economists, but it is not so deeply relevant to the insider trading problem.

b. **Semi-strong form:** The ***"semi-strong form"*** of the ECMH says that "prices reflect all public information, including that in financial statements." Cox, *op. cit*. Thus if IBM is trading on a particular day at $126 per share, everything that is known to the public about IBM's business prospects is already reflected in that $126 price. If the "pure" form of the semi-strong hypothesis is accepted (that the "value" of IBM stock is always exactly reflected in the stock's price, insofar as that value can be determined from publicly available information), then two important corollaries emerge: (1) an investor without inside information ***can never systematically beat*** the market, and in fact the profession of "securities analyst" is worthless; and (2) an investor can always buy any share at any time at the prevailing market price without worrying whether the price is too high or too low, ***because the price will always be "fair"*** in the sense that the price will always reflect all publicly known information.

   i. **Significance:** This corollary (2) is especially important for insider trading law, because it furnishes a way for an investor who has bought without the benefit of inside information to show that he has been harmed. For instance, in our example on p. 252, an investor who bought shares in Oil Co. on July 3 at $30 per share can say, "I relied on $30 per share being a fair price for Oil Co. stock, because I know that the market always reflects all available information about a company's prospects. Had Prexy made prompt disclosure that Oil Co. did not find as much oil as had previously been announced, the price would have dropped, I would have paid $20 a share instead of $30 a share, and I would have avoided an ultimate loss of $10 a share." See the discussion of the "fraud on the market" theory, *infra*, p. 280.

   ii. **Widely accepted:** The semi-strong form of the ECMH is fairly ***well accepted*** by economists. See S,S,&B, pp. 900-01. Actually, for purposes of analyzing insider trading, it doesn't even matter whether the true "value" of a company

is always reflected in its stock. All that is required is that particular ***new pieces of public information*** become ***rapidly reflected*** in the company's share price. Virtually all economists would agree that the semi-strong version of the ECMH is correct in this "information arbitrage" sense. See S,S,B&W, p. 904. In other words, it is well accepted that when a material fact is disclosed, this information is immediately reflected in the stock's price, and the price of a stock is therefore always "fair" in this sense of reflecting all recent publicly known events.

c. **Strong hypothesis:** The ***"strong"*** version of the ECMH says that "prices fully reflect ***all*** information including ***non-public*** or ***'inside'*** information." Cox, *op. cit.* But here, there is a substantial body of evidence that the strong ECMH is ***wrong***, i.e., that stock prices do not always reflect information known to insiders but not known to the public. Cox, quoted at S,S,B&W, p. 903. This means that ***insider trading probably pays off in the long run*** — a person trading on insider information about his company will probably "beat the market." If this is true, it is important, because it means that: (1) insiders do indeed have a strong economic incentive to trade based on inside information; and (2) insiders who trade on their inside information will end up — arguably unfairly — richer than outsiders who play the same securities-trading game.

C. Harms from insider trading: What's wrong with insider trading? Why should there be a huge federal effort to stop it? The possible harms from insider trading can be divided into four main types:

1. **Harm to corporation:** Some people have argued that insider trading hurts the ***corporation*** whose stock is being traded. For example, if a corporation's top managers are seen to be routinely engaging in insider trading in the company's stock, the public may come to view the corporation itself as being sloppily and inefficiently run, and its management as dishonest. This might make it harder for the company to raise money by selling new stock, to find customers for its products, etc.

a. **Weak effect:** However, if this damage-to-the-corporation effect exists at all, it is probably very weak, and is certainly not sufficient to support the very strong public policy against insider trading. Clark, p. 266.

2. **Harm to investors:** Second, insider trading may cause harm to certain ***investors*** who trade during the period of non-disclosure. If investors are injured, the injured ones may be (but will not necessarily be) the ones who actually take the opposite side of the trade with the insider. The injured investors will, however, be the ones who trade ***opposite from the way*** the insider trades (i.e., those who buy when the insider is selling, or who sell when the insider is buying). How are these "opposite traders" harmed?

   a. **How harm might occur:** First, realize that the question that should be asked is not "How has the outsider done less well than the insider?" Instead, the question should be "How has the outsider done less well than he would have done in the absence of insider trading?" In other words, an outsider should be viewed as having being harmed only if he somehow ***does something different*** than he would have done had there been no insider trading.

   b. **Traders who behave differently:** If one believes the semi-strong form of the Efficient Capital Markets Hypothesis, once disclosure of the formerly inside information finally takes place the stock will trade at its "true" value. Therefore, the only investor who can be hurt by insider trading is one who trades ***during the period of non-disclosure***. Furthermore, even an investor who trades during this non-disclosure period is harmed only if his conduct is ***different than it would have been had there not been any insider trading***. For many if not most outsiders who trade during the period of non-disclosure, their conduct (and the financial results to them) are no different than they would have been had there been no insider trading at all — the outsider would have made the trade anyway, and at the same price.

      i. **"Induced" trader:** On the other hand, some outsiders

may indeed take a different action because of the insider's trading.

Example: Assume the same basic facts involving the oil well as in our example on p. 252. But this time, assume that Prexy's purchase of shares on July 1 was large enough relative to the other trading in the stock that it *raised the price* of Oil Co. shares from $20 to, say, $23 per share. Now, assume that Outsider would never have sold out at the pre-July-1 price of $20, but that the rise to $23 *induced* him to sell.

Here, we can at least make a plausible case that Outsider has been directly harmed by the insider trading: he has been "suckered" into selling for a small gain ($3 per share over the earlier price) whereas, had Prexy not caused the price to rise $3 by his insider trading, Outsider could instead have benefited from a sudden rise to $30 when the company eventually made its announcement about the gusher. So such an "induced" seller (and, conversely, an outsider who is induced to buy by a small drop that results from insider's selling before the disclosure of bad news) are the only kinds of investors who can really be said to have been directly harmed by the insider trading. See Wang, 54 S.Cal.L.Rev. (cited in S,S,B&W, pp. 910-11).

(1) Large traders: Observe that this harm to "induced" sellers and buyers will only occur where the insider trading is ***large enough*** relative to the non-insider trading in the stock that the insider trading ***affects the market price***. S,S,B&W, p. 911.

3. Delayed disclosure: Perhaps the most concrete harm from insider trading is that it interferes with the ***prompt disclosure*** of important corporate information that should (and would) otherwise be immediately released to the public. For instance, in our oil well example, Prexy might have caused Oil Co. to ***immediately announce*** the gusher as soon as it was discovered on July 1; his desire to trade on the inside information caused him to delay the disclosure at least long enough to carry off his

insider trading.

a. **Nature of harm:** Why is such delayed disclosure bad? Three plausible reasons can be given:

   i. **Inefficiencies:** First, it distorts the ***efficiency*** of the capital markets — stock prices are less often "correct" because the information they are responding to is more often out-of-date. Consequently, our economy will not be ***allocating its resources*** as well.

   ii. **Equal access:** Secondly, most of us have a basic psychological and moral sense that the markets should function on the basis of ***equal access to information***. A market in which insiders have information that (because of delayed disclosure) outsiders do not have, is like playing in a card game where the other guy has a marked deck. Indeed, this generalized notion that fairness requires equal access to information is probably the single most important factor behind the rules against insider trading.

   iii. **Harm to market:** A third, related, harm from delayed disclosure is that if investors in general believe that insiders have the advantage (that the game is "unfair"), they are likely to ***boycott the stock market***. If there are fewer investors than there otherwise would be (or if investors demand a higher return on their investment for putting up with the perceived unfairness of insider trading), firms' ***cost of capital will rise***. This will in turn disadvantage the corporate sector of the economy vis-a-vis other investments (e.g., treasury bills), and will make it harder for the corporate sector to grow.

4. **Harm to efficiency from secret profits:** Finally, the pursuit of insider trading may cause managers to run their companies in an ***inefficient manner***. If we completely legalize insider trading, insiders would probably be able to make trading profits that are much larger than the salaries they now receive. This might lead them to be less diligent in increasing shareholder value. (For instance, they might concentrate their energies on spotting

opportunities to sell the company's shares short in anticipation of soon-to-be-released bad news, rather than on running the company well.) Also, they might be inclined to take ***riskier actions*** than the outsiders would want. (Their main incentive, as managers primarily interested in trading profits, would be to cause large changes in the company's prospects, to be followed by large moves in the stock; because of their ability to engage in either purchases or short-sales, they wouldn't care so much whether the results increased the company's share price.) See Clark, pp. 274-75.

D. Arguments in support of insider trading: A small group of commentators has argued that insider trading has ***beneficial*** effects, and should be tolerated if not encouraged. Here are the two principal arguments made in behalf of insider trading:

1. Market price quickly reflects new information: First, insider trading arguably causes the company's stock price to ***better reflect new (unannounced) developments***. There are two asserted sub-benefits: (1) stock prices ***move more smoothly***; and (2) a company's stock price is ***closer to its "true" value*** at most times, than where there is no insider trading and the previously secret information is suddenly announced, causing a sharp rise or drop in the stock price. (This, in turn, is asserted to be economically desirable because "correct" stock pricing helps allocate capital efficiently. See *supra*, p. 256.)

2. Compensation for entrepreneurs: Second, the advocates of insider trading argue that it often furnishes reasonable ***compensation*** for managers, and gives otherwise risk-averse managers an additional incentive to take riskier, but nonetheless economically sensible, corporate action. Under this argument, "a manager will be more willing to take risks if he knows that he can profit by selling short prior to public disclosure of the failure." S,S,B&W, p. 914.

a. Criticism: But this argument is even more strongly criticized by the anti-insidertrading forces. The critics point out that if this argument is correct, the manager won't care whether the

company does well or badly, since he can profit in either case. Therefore, his incentive to run the firm in a way that enhances its value for outside shareholders will be compromised. Also, it is doubtful whether the bulk of insider traders are corporate "entrepreneurs" who will if properly motivated create true value for the corporation; they are just as likely to be lower-level functionaries who will have no real impact on the firm's fortunes either way, and who therefore do not need any of this special insider trading "incentive compensation." See Clark, p. 279.

E. **Summary:** In summary, most observers believe that insider trading is, on balance, ***harmful***. Certainly federal law (and, increasingly, the laws of many states) reflect uniformly the belief that insider trading is unfair to public investors and economically inefficient.

F. **Summary of law:** There are three principal bodies of law that proscribe and punish insider trading (or, at least, certain types of insider trading). We will be considering each of these in some detail below. For now, let us just mention each:

1. **State common law:** A few states bar certain kinds of insider trading by the application of ***state common-law*** principles. The states are especially likely to bar trading by an insider that is accompanied by ***face-to-face fraud*** (e.g., the insider simply lies about the company's prospects while making a face-to-face trade with an outsider). In the more common situation of an insider buying or selling on the impersonal ***stock market***, while simply remaining silent about the existence of material non-public information, apparently ***only one state court*** has found the insider liable under common-law principles; see *Diamond v. Oreamuno*, *infra*, p. 261.

2. **Federal SEC Rule 10b-5:** Most importantly, the federal SEC Rule 10b-5 prohibits any fraudulent or manipulative device in connection with the purchase or sale of a security. This has been interpreted to bar ***most kinds of insider trading***. A violation of 10b-5 can give rise to criminal liability, to SEC injunctive

proceedings, and to a private right of action on the part of outside investors who have been injured. Our extensive discussion of 10b-5 begins on p. 262.

3. **Short swing profits:** Finally, §16(b) of the federal Securities Exchange Act makes insiders liable to repay to the corporation all profits they make from so-called ***"short swing trading profits."*** Briefly, if the insider buys and then sells within a six month period, or sells and then buys within a six month period, he must ***repay to the corporation*** all of the profits. This is true whether the insider is actually relying on material non-public information or not — it is a categorical rule designed to remove much of the incentive from at least short-swing insider trading. See *infra*, p. 305.

G. **Who can recover:** Even where it is clear that the insider is civilly liable for insider trading, an important issue remains: ***who*** can recover? Usually, the choice is between allowing recovery by the ***corporation itself***, or allowing the recovery to go to certain ***outside investors*** who have in some way been harmed by the insider's trading. In the Rule 10b-5 context, it is usually the private investors who recover. In the §16(b) cases, by contrast, it is always the corporation that recovers.

II. STATE COMMON-LAW APPROACHES

A. **Common-law rules generally:** State common law has placed only very minor limits on insider trading. Therefore, most barriers to insider trading today come from federal rather than state regulation. However, because federal private suits against insider traders have become somewhat harder to bring since 1976, state law remedies may become more important. Therefore, it is worth spending some time on the state common law that pertains to insider trading.

B. **Suits by shareholders:** First, let's consider an action by a ***shareholder*** against the insider trader.

1. **Action for deceit:** A shareholder plaintiff who wants to sue an

insider trader under state law will generally have to use the common-law action of ***deceit***. Traditionally, the plaintiff in a deceit action has been required to show five things: (1) that P justifiably ***relied***; (2) to his ***detriment***; (3) on a ***misrepresentation*** of a material fact; (4) made by the defendant with ***knowledge*** of its falsity (or at least with reckless disregard for its truth); and (5) with ***intent*** that the plaintiff rely. See S,S,B&W, p. 919-20.

a. Misrepresentation: Where the insider makes an actual ***misrepresentation*** in a ***face-to-face*** transaction with the plaintiff, the plaintiff has a reasonable chance of winning in a deceit action. So if Insider says to Outsider, "Our profits are going to be down next quarter," and this knowing falsehood induces Outsider to sell to Insider cheaply, Outsider has a *prima facie* case for deceit at common law.

b. Half-truth: In fact, the insider will be liable under general common-law deceit principles if he knowingly tells a ***half-truth***, i.e., he discloses part of the truth, but his failure to disclose the rest of the truth has the effect of misleading the other party. For instance, if Insider truthfully tells Outsider, "Profits will be down this quarter," but neglects to mention that a third party has offered to buy the company at an above-market price, Insider's statement is a half-truth that will probably give rise to liability for deceit if Outsider is induced to sell cheaply to Insider. C&E, p. 815.

c. Silence: But where the Insider simply ***remains silent*** and buys or sells based on material non-public information, the common-law remedy of deceit is of little use. The problem is that, as noted above, one of the requirements for an action in deceit is a ***misrepresentation***, and the insider who silently buys has simply made no misrepresentation. The "silent insider" problem is discussed more fully immediately below.

2. Silent trading: In general, the common law does ***not*** impose upon a party to a transaction any ***duty to disclose*** facts known to him. There *is* a duty to disclose where the defendant has some

fiduciary responsibility to the plaintiff, growing out of some special relationship between them. But the majority common-law rule is that an insider (officer, director or controlling shareholder) has a fiduciary obligation only to the corporation, not to other present or prospective shareholders. Therefore, there is simply ***no way*** for an investor to bring a successful deceit action against the insider who buys or sells ***silently*** based on ***inside information***.

Example: D1 (president and director of Cliff Mining Co.) and D2 (a director of Cliff) are aware that an experienced geologist believes that copper deposits will be found under the company's land. At a time when the public (including P) does not know of this geological prediction, P sells his Cliff shares on the Boston Stock Exchange, and those shares happen to be bought by the Ds. P brings a common-law deceit action, arguing that had he known of the geologist's report, he would not have sold his shares.

Held, for the Ds. Directors and officers of a company may owe a fiduciary responsibility to the company, but they do not owe any fiduciary responsibility to individual shareholders. Therefore, the Ds had no obligation to P to make any kind of disclosure prior to the purchase. "An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew.…" *Goodwin v. Agassiz,* 186 N.E. 659 (Mass. 1933).

a. **Impersonal transactions:** In the case of ***impersonal transactions*** on the stock exchange, *Goodwin* represents not only the majority but essentially the sole rule: the insider who ***buys silently on the exchange*** simply has ***no common-law liability to the other party*** to the trade.

b. **Face-to-face transactions:** Where the insider buys from the outsider in a ***face-to-face*** transaction, the majority rule still seems to be that the insider has ***no affirmative duty of***

disclosure, and is therefore ***not liable if he simply remains silent.*** C&E, p. 814-15. But in this face-to-face situation, there are some well-accepted ***exceptions***, as well as a minority rule:

i. Fraud: First, if the insider knowingly ***lies*** or tells a ***half-truth***, he will be liable under ordinary deceit principles, as discussed above.

ii. "Special facts" exception: Second, many states recognize a ***"special facts"*** exception to the majority rule that silence cannot constitute deceit. Under this loose exception, if there are special facts that make the insider's conduct ***especially unfair***, he will be liable even though he remains silent. For example, if he ***seeks out*** the other party to the transaction, or if he makes affirmative efforts to ***conceal*** either his own identity or material facts about the company's fortunes, the court is likely to find the requisite "special facts" and impose liability.

Example: D is a director and three-fourths owner of Philippine Sugar Co. The company is in bad financial shape, and the public knows that the only way the shares will go up is if the company is able to sell its properties to the U.S. government. The negotiations have dragged on for a long time, and the public believes they will fall through. D (who as three-fourths owner and director controls the price at which the company will sell) secretly resolves to consummate the sale to the government. D learns that P has some shares for sale. D has an intermediary use a broker to buy P's shares, in such a way that P never learns that D is the purchaser or that D is about to consummate the sale to the government. The price D pays for P's shares is one-tenth what the shares become worth three months later after the sale to the government is carried out.

Held, P can recover against D for fraud. The special facts here, including D's total control over whether and when a sale would be made to the government and his concealment of his identity from P, would make it unjust to deny P a recovery against him. *Strong v. Rapide*, 213 U.S. 419

(1909).

iii. Minority rule: Furthermore, a minority of states have imposed the more general rule that in face-to-face negotiations, an insider has an affirmative ***obligation to disclose*** material facts known to him. This minority rule is sometimes called the "Kansas Rule."

3. Summary: So at common law, if Insider buys from Outsider in a face-to-face transaction, Outsider can recover if any of the following is true:

(1) Insider ***affirmatively lies*** to Outsider about the company's prospects;

(2) Insider tells a ***misleading half-truth***;

(3) there are ***"special facts"*** making Insider's conduct unfair (e.g., he has ***concealed his identity*** from Outsider); or

(4) the jurisdiction follows the ***minority*** or "Kansas" rule, and Insider has failed to make full disclosure.

a. Not covered: But in cases where the transaction is not face-to-face, and is instead carried out through the impersonal stock exchanges, and in cases where the insider remains completely silent in a jurisdiction that follows the majority rule (as in *Good-win*), the common-law approach leaves the outsider with no remedy for insider trading.

b. No recovery against seller: Also, apparently no case has ever awarded a recovery against an insider who ***sold*** on the basis of inside information. This may be because everyone has assumed that an insider couldn't possibly owe any kind of duty of disclosure to one who was ***not yet*** a stockholder. Clark, p. 311.

c. Weak remedies: So in general, the common-law remedies for insider trading have been very ***weak*** at best.

C. Recovery by corporation: Given the difficulties that individual shareholders find at common law in recovering for insider trading, may the ***corporation itself*** recover for insider trading in its shares

by one of its officers or directors?

1. **Harm to corporation:** First, consider the situation in which the corporation is ***actually harmed*** by the insider's trading in its shares. There are practically no cases on the subject, but general duty-of-loyalty and duty-of-care principles (*supra*, pp. 197 and 169) suggest that the corporation could recover at common law for the damage to it. A court could quite plausibly hold that the insider information used by the officer or director was really a ***corporate asset***, and that the insider may not put his own interests ahead of the interests of the corporation in the use of that asset.

   Example: Suppose that Insider, a director of Corporation, knows that Corporation will soon be buying back a large portion of its shares from public shareholders. Insider expects that the announcement of this buy-back will cause the shares to rise. Before the announcement, he buys an additional 5% of Corporation's shares himself, thereby driving up the price. When Corporation carries out its buyback, it is forced to pay a higher price because of the rise due to Insider's purchases. A court would probably allow Corporation to recover from Insider for the extra amount it had to pay, on the theory that Insider breached his duty of loyalty to Corporation by appropriating the information (knowledge of the impending buyback).

2. **No corporate harm:** But in the usual insider trading situation, the corporation will ***not*** suffer direct financial or other quantifiable harm. If the corporation suffers no direct loss, may it nonetheless recover against the insider on the theory that he has been unjustly enriched by his use of a corporate asset (the inside information)? Only ***one major case*** has ever answered ***"yes."*** This is the New York Court of Appeals' decision in *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969).

   a. **Importance of *Diamond*:** In *Diamond*, the New York Court of Appeals essentially held that inside ***information is a corporate asset***, and that an insider who profits by trading

upon that information has ***violated his fiduciary duty to the corporation*** and must ***turn over to the corporation any profits he has made*** (or losses he has avoided) from the trading, even though the corporation did not suffer direct financial loss.

b. Rejected by other courts: ***No other state court*** has accepted the rationale of *Diamond*, and thus no court has allowed recovery on behalf of the corporation where the corporation cannot show direct injury from the insider trading. Nutshell, p. 340.

c. ALI follows *Diamond*: But the ALI's Principles of Corporate Governance ***follow Diamond***. ALI §5.04(a) provides that:

§5.04 Use by a Director or Senior Executive of Corporate Property, Material Non-Public Corporate Information, or Corporate Position

(a) *General Rule.* A director or senior executive ***may not use*** corporate property, ***material non-public corporate information***, or corporate position to ***secure a pecuniary benefit***, unless either: …

(3) The use is solely of ***corporate information***, and is ***not in connection with trading of the corporation's securities***, is not a use of proprietary information of the corporation, and does not harm the corporation; …

i. Extensive liability: The ALI says that even if the corporation does not suffer any actual harm, it may recover for ***"unjust enrichment"*** by the insider, under §5.04(a)(5). In fact, the ALI section goes even further than any reported case has, to contemplate the possibility that a ***tippee*** (one who receives the non-public information from an insider, and uses it for his own benefit) may also be liable under this provision, perhaps on the theory that the tippee has knowingly participated in a breach of the duty of loyalty owed by the insider to the corporation. §5.04, Comment d(2)(a).

III. SEC RULE 10b-5 AND INSIDER TRADING

A. Securities Exchange Act §10(b): Section 10 of the Securities Exchange Act of 1934 (the "'34 Act") provides:

Regulation of the use of manipulative and deceptive devices.

> It shall be ***unlawful*** for any person, ***directly or indirectly***, by the use of any means or instrumentality of ***interstate commerce*** or of the mails, or of any ***facility of any national securities exchange*** …
>
> > (b) to use or employ, ***in connection with the purchase or sale of any security*** registered on a national securities exchange or any security not so registered, any ***manipulative or deceptive device*** or contrivance in ***contravention of such rules and regulations*** as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

1. **Analysis:** Notice that nothing is directly made illegal by this §10(b) — only to the extent that the SEC enacts a ***rule*** prohibiting certain conduct pursuant to this section can there be any criminal liability. Furthermore, observe that nothing in §10(b) gives any hint that investors injured by fraudulent conduct of the sort that §10(b) seems to be directed at would have a ***private right of action***.

B. SEC's enactment of Rule 10b-5: It was not until 1942 that the SEC finally enacted a rule that would put some meat into the general anti-fraud prohibition of §10(b). The Commission did this by enacting ***Rule 10b-5*** (i.e., its fifth rule pertaining to section 10(b) of the '34 Act). That rule reads today as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> > (a) to employ any device, scheme, or artifice to ***defraud***,
> >
> > (b) to make any ***untrue statement of a material fact*** or to ***omit to state*** a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> >
> > (c) to engage in any act, practice, or course of business which operates or would operate as a ***fraud*** or ***deceit*** upon any person
>
> ***in connection with the purchase or sale of any security***.

1. **Purpose:** The rule was initially enacted to prevent insiders from making explicit fraudulent statements to investors about how ***badly*** the company was doing, so that the insiders could buy up the shares cheaply. At the time of its enactment, the Commission staff did not focus on the typical insider-trading paradigm (purchases or sales by insiders who remain completely ***silent*** about the company's condition). And the Commission certainly did not foresee that the rule might give rise to a private right of action by investors; it was intended solely to let the SEC

stop fraudulent activity. *Id.*

2. **Broad application:** But the actual application of Rule 10b-5 has grown far beyond what the Commission intended at the time of drafting. Perhaps the three most important extensions are:

   (1) The rule applies to ***any form*** of deceit or fraud, including the garden-variety case in which the insider ***silently*** buys or sells on material non-public information (and thus never makes any affirmative misrepresentation);

   (2) The rule applies to one who makes a ***misrepresentation*** that induces others to buy or sell, even if the ***maker*** of the misrepresentation ***never buys or sells*** himself; and

   (3) Perhaps most dramatically, an investor who meets several procedural requirements may bring a ***private suit*** alleging a violation of 10b-5, and may recover damages for that violation.

   Our detailed treatment of Rule 10b-5 will consider in detail each of these extensions, among other issues.

3. **What constitutes insider trading:** Before we get into the details of 10b-5, let's summarize, in a semi-accurate way, the elements that must be present before a defendant will be found to have insider-traded in violation of 10b-5. In this discussion, we're not considering who may sue.[1]

   D will be found to have insider-traded in violation of 10b-5 if (and only if) all these elements are present:

   - ❑ D ***bought or sold stock*** in a company (the "issuer"). The issuer will usually be, but need not be, a publicly-traded company.

   - ❑ At the time D bought or sold, he was in possession of ***information*** that was ***"material,"*** i.e., would be considered ***important to a reasonable investor*** in the issuer's stock.

   - ❑ The material information (referred to in the prior step) was ***non-public*** at the moment D bought or sold.

- ❑ D had a ***special relationship*** with the ***source*** of the information (either the issuer or someone else who possessed the inside information[2]). D meets this requirement if he was a true ***insider*** of the issuer (e.g., an employee), or was a ***"constructive insider"*** (i.e., in possession of confidential information that the issuer temporarily entrusted him with, such as a lawyer working as outside counsel for the issuer). He also meets it if he was a ***"tippee,"*** who was given the information by an insider (a "tipper") in violation of the insider's fiduciary duty. Lastly, he meets the requirement if he was a ***"mis-appropriator,"*** i.e., an "outsider" vis a vis the issuer who gets the information from ***one other than the issuer*** (e.g., from a potential acquirer of the issuer), in breach of a promise of confidentiality.

- ❑ D meets the ***jurisdictional requirements***. That is, he traded "by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange." In the case of a publicly-traded stock, this requirement is always met.

C. Development of 10b-5's application to insider trading: It took two developments to make Rule 10b-5 a really useful weapon against insider trading: (1) the judicial conclusion that there should be an ***implied private right of action*** for violations of 10b-5; and (2) the conclusion that 10b-5 covers insider trading that takes place ***without any affirmative misrepresentation*** by the insider.

1. Implied private right of action: Almost from the beginning, the courts have held that when a person violates 10b-5, an investor injured by this violation may bring a ***civil suit for damages***, based on the violation. The text of 10b-5 itself (or, for that matter, the text of §10(b) of the '34 Act, under which 10b-5 was promulgated) nowhere mentions any private civil action — the Rule consists merely of the SEC's statement that fraudulent or manipulative devices will be "unlawful." But the courts have consistently held that since investors in a company's securities are members of the class that the Rule was designed to protect, they should be able to recover in damages for violations of the

Rule. (This is really nothing more than a federal application of the well-known state common-law principle allowing tort claims to be based upon statutory violations, as in the negligence *per se* doctrine. See Clark, p. 313.)

a. **Explicit statutory right of action:** At least some private actions based on 10b-5 are now ***expressly*** authorized by statute. In 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). Section 20A of the '34 Act (added by ITSFEA) allows P to sue D if D bought or sold on inside information, and P bought or sold on the opposite side of the trade ***"contemporaneously"*** with D's trades. Section 20A is discussed more extensively *infra*, p. 283.

2. **Application to insider trading:** Rule 10b-5 certainly does not expressly state that an insider who buys or sells based on material non-public information, without making any affirmative misstatements, has engaged in "fraud or deceit." So it is not obvious from the text of 10b-5 that it applies to garden variety "silent" insider trading at all. But the SEC concluded that such garden variety insider trading does violate 10b-5, in its landmark opinion in *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

3. **"Disclose or abstain" rule:** *Cady, Roberts* is also noteworthy as the first case in which the SEC articulated its ***"disclose or abstain"*** rule. Proponents of insider trading (and defendants in insider trading cases brought under state and federal principles) often argue that if the insider is required to disclose the inside information, the disclosure will happen ***prematurely*** and the corporation may suffer. But the SEC's answer to this argument is that the insider has a ***choice***: he must ***either*** disclose the inside information or abstain from trading. In other words, the insider is ***never required by 10b-5 to make disclosure of any facts***, no matter how material; all that 10b-5 requires is that the insider ***not trade while in possession*** of such undisclosed information.

a. **Affirmative obligations:** This "disclose or abstain from trading" rule remains the law. It also remains the case (at least

as a matter of federal securities law) that ***companies*** and insiders ***never have an affirmative duty to disclose a material fact*** that, in their rational business judgment, they think would better serve the company's interests by remaining nondisclosed. Of course, in the case of a public company, eventually documents will have to be filed with the SEC (e.g., the 10-Q quarterly report and 10-K annual report) that must disclose material developments; also, the rules of the various stock exchanges typically require immediate disclosure of "ripe" material company information. And, of course, the company itself is an "insider," so if it has not released material news, it may not ***buy back*** its own shares or sell new ones to the public. But there is no federal provision that makes it a crime to fail to disclose material information, so long as no stock trading takes place during the period of nondisclosure.

4. **Private companies:** Perhaps surprisingly, Rule 10b-5 applies to fraud in the purchase or sale of securities in ***privately held*** companies as well as publicly held ones. 10b-5 itself refers merely to fraud, deceit, etc. in connection with the purchase or sale of "any security." "Security" is defined in §3(10) of the '34 Act in a very general way, with no limitation to publicly held stock. Therefore, if D sells P all of the stock of Dry Cleaning Corp., a corporation solely owned and operated by D which runs a drycleaning business, P actually has a federal securities-law claim if he can show that D made intentional misrepresentations about the company (assuming the other procedural requirements for 10b-5 actions are met).

5. ***Texas Gulf Sulphur* case:** Before we begin looking at the individual issues raised by Rule 10b-5's application to insider trading, it's worth looking in detail at a seminal case: ***SEC v. Texas Gulf Sulphur Co.***, 401 F.2d 833 (2d Cir. 1968). This case is important for several reasons: (1) Because it involves complex, evolving facts (indeed, it reads a lot like a law school exam question!), it will give you a good sense of the various insider trading problems that can come up in ordinary corporate life; (2) It was the first major case in which a court (rather than

just the SEC) asserted that silent trading in the impersonal securities markets on the basis of material non-public information violated 10b-5; (3) It was the first major case in which the SEC successfully compelled insiders to disgorge their trading profits, thus encouraging a raft of private actions for damages; and (4) It was decided by a very smart and well-respected court, the Second Circuit (sitting *en banc*).

a. Facts: Texas Gulf Sulphur (TGS) had been looking for minerals in eastern Canada for a number of years. In early November, 1963, it drilled a test hole at K-55-1 near Timmins, Ontario. This test core showed a higher percentage of minerals (copper, zinc and silver) than TGS's geologists had ever seen before. From November until February, 1964, TGS stopped drilling to keep its find confidential (and so that it could obtain leases on additional nearby acreage).

i. Shares bought: During this non-drilling period, various employees of TGS, including four members of the geological team, the president, the executive vice president, the general counsel and a director bought lots of TGS stock and "calls" (options to buy) on TGS stock.

ii. Options issued: Also during this non-drilling time, TGS issued stock options to a number of high-level employees, including five who knew about the Timmins find. (The board of directors and the Stock Options Committee, at the time they awarded these options, did not know of the Timmins find.)

iii. Misleading press release: Drilling resumed in late March, 1964, and immediately produced very favorable results. Rumors about a major ore strike began to circulate. To diffuse speculation the company released on April 12 a ***press release*** that said that the rumors "exaggerate the scale of operations" at Timmins, and that the work done to date "has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading." But in fact, at the

moment of the news release TGS had already discovered at least $150 million worth of minerals.

- **iv. Final announcement:** TGS finally made the press release announcing a sizable strike on April 16. Some of the employees of TGS who knew of the strike continued to buy stock between the April 12 press release and the final April 16 announcement.
- **v. Stock price:** The stock price had increased gradually during the entire time following the original November 8 test core: When drilling began, the stock traded at around $17. The day TGS finally announced the strike, the stock closed at $36.
- **vi. SEC's suit:** The SEC sued the employees who had traded with knowledge of the probable strike between November 8 and April 16; it sought to make them disgorge their trading profits. It also sued TGS itself, on the theory that although TGS did not buy or sell its own shares during this period, by issuing the misleading April 12 press release it induced outsiders to sell at prices lower than they would have gotten had the misleading release not been issued.

b. Holding: The court found ***in favor of the SEC*** on virtually all points. A number of aspects of the court's holding are worthy of special notice:

c. Court adopts "disclose or abstain" rule: The court adopted the ***"disclose or abstain"*** rule urged by the SEC, under which an insider with material non-public information must choose between disclosing it to the public or abstaining from trading in the stock.

d. "Material" inside information: The court defined ***"material"*** inside information to be information "[to which] a reasonable man would ***attach importance*** … in determining his choice of action in the transaction in question." This definition was later adopted by the Supreme Court in *Basic Inc. v. Levinson*, *infra*, p. 272. The insiders were not required

to give outsiders the benefit of their “financial or other expert analysis” or to disclose their “educated guesses or predictions.” But the basic objective fact — that drilling had produced test cores with a high mineral content — was clearly the kind of fact that an investor would regard as important in deciding whether to buy, sell or hold, and was therefore “material.”

i. **Importance attached by those who knew:** An interesting aspect of the court’s treatment of “materiality” was that it attached great significance to the importance that a fact holds to ***those who know about it*** inside the company. Here, the frenetic pattern of trading activity by those who knew of the drilling results was strong circumstantial evidence that these insiders thought the fact was important, and thus strong evidence that the drilling results were “material.”

e. **Time to disseminate information:** The court held that it is not enough that the insiders have waited until the company has made a public announcement of the inside information. Rather, they must wait until this information has been ***widely disseminated*** to the marketplace. For instance, the insiders were required to wait until the news had appeared over the most widely-circulated medium, the Dow Jones “broad tape,” not merely until the news had been read to members of the press.

f. **Receipt of stock options:** The court held that it was a form of insider trading for a high-level executive to ***receive stock options***, where the executive knew the inside information and the committee awarding the stock options did not. In other words, receipt of stock options by, say, the corporation’s general counsel occurred “in connection with the purchase or sale of any security” (Rule 10b-5’s language) even though the options were in a sense “given” to him. (But option recipients below high-level management were found not have any duty to disclose or refuse the options).

g. **Press Release:** Finally, the court held that ***TGS itself***, even though it did not buy or sell its own securities, could be found to have ***violated*** 10b-5 if it failed to use due diligence in preparing its news release. The release's great generality (at a time when much more interesting and specific information was available) was itself enough to make the report "misleading." (Today, it remains the case that a corporation can have 10b-5 liability for misleading statements even where it does not buy or sell its own stock; however, the corporation must be shown to have known of the falsity or recklessly disregarded the danger of falsity, so that a mere lack of due diligence as in *Texas Gulf Sulphur* would not suffice. See *infra*, p. 268.)

h. **Remand:** On remand, the district court ordered all TGS insiders who had bought stock or call options before the April 16 press release to ***disgorge their profits***. That is, they were required to pay the difference between the average price for TGS stock the day after the final disclosure, and the amount they had previously paid for the stock. The insiders were also required to pay damages equal to any profits made by their ***tippees*** (i.e., outsiders who learned of the drilling from the insiders). All of these damages were to be held for five years in a fund, which would be used to pay damages to outside investors who were injured by the insider trading (e.g., those who sold during the non-disclosure period for less than they would have gotten had disclosure been made). Any sums not paid over to private claimants at the end of five years were to become the property of the ***corporation*** itself. (In other words, to the extent that there were no successful private claimants, the action would be treated as if it had been a shareholder's derivative action.) *SEC v. Texas Gulf Sulphur Co.*, 312 F.Supp. 77 (S.D.N.Y. 1970), *aff'd* 446 F.2d 1301 (2d Cir. 1971).

D. **Requirements for 10b-5 private action:** As we noted previously, an outsider injured by insider trading may bring a private damage action under Rule 10b-5. However, the Supreme Court has set up a

number of hurdles that the plaintiff must jump over in order to recover in this manner. Several of these requirements were imposed after 1975, when the Supreme Court apparently decided to make such actions tougher to bring. These requirements apply to all 10b-5 actions, whether based on an affirmative misrepresentation, a half-truth, or an omission to state material facts. (The usual insider trading case — involving an insider's "silent" trading while in possession of material non-public information — falls into the "omissions" sub-category; this sometimes introduces a special twist to the rules, and I comment on these twists separately.)

In any event, today the requirements for a successful 10b-5 damages suit seem to be as follows:

1. **Purchaser or seller:** The plaintiff must be a ***purchaser*** or ***seller*** of the company's stock during the time of non-disclosure. For instance, it is not enough that the plaintiff ***declined to buy*** because of false statements made by the company or an insider. See *Blue Chip Stamps v. Manor Drug Stores*, *infra*, p. 269.

2. **Traded on material non-public info:** The defendant must have misstated or omitted a ***material*** fact. If the claim is that the insider has traded "silently" (rather than by making a misrepresentation), then the silence is an omission that is "material" only if the undisclosed fact would have been ***important to a reasonable investor.*** (Remember that the insider has no affirmative duty to disclose, merely a duty to ***either*** disclose or abstain from trading.)

3. **Special relation:** If the claim is based on insider trading, the defendant must be shown to have had a ***special relationship*** with the issuer (or with someone other than the issuer who possessed the inside information), based on some kind of ***fiduciary duty***. For instance, if D happens to overhear a conversation in a restaurant that relates to XYZ Corp., a company that he has no other contact with, D has no duty to disclose or abstain, and he can thus trade freely on this inside information. See *Chiarella v. U.S.*, *infra*, p. 274. (Generally, this requirement of a special relationship means that D must be shown to be either an ***insider***,

or one who learned the information from the insider with knowledge that the insider had a fiduciary responsibility to protect the information, or a "misappropriator" who steals the information from someone. See *Dirks v. SEC, infra*, p. 276; *U.S. v. O'Hagan*, *infra*, p. 291.)

4. **Scienter:** The defendant must be shown to have acted with ***scienter***. In other words, the defendant must be shown to have had a mental state "embracing intent to ***deceive, manipulate, or defraud***." In the usual "silent" insider trading situation, this requirement is of little practical importance. But in the case of a defendant who is accused of having made an affirmative misrepresentation or half-truth, the requirement is important, because it forecloses liability for mere negligence. See *Ernst & Ernst v. Hochfelder*, *infra*, p. 277.

5. **Reliance:** The plaintiff must show that he ***relied*** on the defendant's misstatement or omission. In the case of an omission (as in the usual "silent" insider trading situation), this requirement is of little importance, because it is generally satisfied by giving the plaintiff the benefit of a presumption that he relied on the market price's being "fair." See *Basic Inc. v. Levinson*, *infra*, p. 280. (In fact, §20A of the '34 Act, added in 1988, expressly gives any person who has bought or sold stock the right to sue any person who insider-traded in the opposite direction at the same time; no showing of reliance on the defendant's omission is required. See *infra*, p. 282.)

6. **Proximate cause:** The defendant's conduct must be shown to have been the ***proximate cause*** of the plaintiff's loss. In the usual silent insider trading situation, this requirement, like the requirement of reliance, is of little importance. For instance, P need not show that he traded directly with D; the mere fact that P bought at the market price, and this market price would have been different had D discharged his duty to disclose before trading, will be enough to show proximate cause. See *infra*, p. 281.

7. **Jurisdiction:** Don't forget that there's a ***federal-jurisdictional***

requirement for a 10b-5 action: the defendant must be shown to have done the fraud or manipulation "by the use of any means or instrumentality of ***interstate commerce*** or of the ***mails***, or of any ***facility of any national securities exchange."*** ('34 Act, §10(b).)

a. **Normally met:** In the case of any ***publicly-traded security***, this requirement will readily be ***met***, even if the defendant ***didn't himself or itself buy or sell.*** Thus an issuer or executive who issues, say, a misleading press release (as in *Texas Gulf Sulphur*) can be liable even though it/she never bought or sold stock, as long as the release is reasonably connected to someone else's purchase or sale (e.g., a member of the public).

b. **Private face-to-face transactions:** But where the fraud consists of deceit in a ***face-to-face sale of shares***, especially shares in a ***private company***, then the jurisdictional requisites may well be ***lacking***.

Example: Prexy, owner of a majority position in privately-held Corp., tells Dupe, in a face-to-face meeting, "Our financial position is extremely strong." In that same meeting, Prexy sells shares in Corp. to Dupe. Unless there's some other interstate aspect to the transaction (e.g., use of the mails in connection with it), Prexy will have no 10b-5 liability because the transaction does not meet the jurisdictional requirements of §10(b) of the '34 Act. That is, the transaction didn't use "any means or instrumentality of interstate commerce or of the mails," and it didn't use any "facility of any national securities exchange."

8. **Detailed treatment:** We consider the first six of the above requirements in more detail beginning immediately below.

E. **Plaintiff must be purchaser or seller:** The plaintiff in a private 10b-5 action must be either a ***purchaser*** or ***seller*** of stock in the company to which the misrepresentation or insider trading relates. The Supreme Court so held in ***Blue Chip Stamps v. Manor Drug Stores***, 421 U.S. 723 (1975), a case which marked the beginning of the Court's efforts to make it much harder to bring a private 10b-5 action.

1. **Facts:** The Blue Chip Stamp Company agreed to settle an antitrust claim by offering shares in itself to certain retailers who had previously used the company's stamp service. This stock offer was on terms quite favorable to the retailers, and presumably Blue Chip knew that any shares not bought under this compulsory offering could later be sold to the public at higher prices; this is what in fact happened. Some of the retailers who did not buy in the compulsory offering then brought a class action suit claiming that Blue Chip had made its prospectus misleadingly ***pessimistic***, for the purpose of inducing them not to buy so that the shares could be sold to the public at higher prices.
2. **Holding:** The Court held that this class of disappointed retailers could not bring a 10b-5 action. Rule 10b-5 by its express terms prohibits only deceit that occurs "in connection with the purchase or sale of any security." (Last phrase of 10b-5.) The Court interpreted this phrase to mean that the plaintiff must have been an ***actual purchaser or seller*** of shares. Here, the retailers' claim was that because of the defendant's misrepresentations, they did ***not*** purchase shares, so the claim was simply not within the scope of 10b-5. The Court thus approved the "purchaser or seller" requirement previously imposed by nearly all lower courts, a rule that had become known as the "*Birnbaum*" doctrine.
3. **Practical consequence:** The practical consequences of the "purchaser or seller" requirement of *Blue Chip Stamps* are actually quite ***small***. Most cases involving misrepresentations in prospectuses are brought by those who actually buy in reliance on a misleadingly ***optimistic*** prospectus, and these plaintiffs of course satisfy the "purchaser or seller" requirement. In the usual garden-variety insider trading case, the plaintiff will be one who sold without knowledge of the favorable news, or bought without knowledge of the unfavorable news; these plaintiffs, too, satisfy the requirement. As the Court in *Blue Chip Stamps* noted, there are really only three types of plaintiffs who are likely to be affected by the rule, and these will either be able to circumvent the rule or will rarely have a plausible claim even apart from the

rule:

a. **Potential purchasers who don't buy:** The first class affected by the "purchaser or seller" requirement consists of potential purchasers of shares who claim that they decided not to purchase because of an ***unduly pessimistic statement*** (or omission of favorable material) by the issuer. The Ps in *Blue Chip Stamps* itself fell into this class. But such plaintiffs are quite rare.

b. **Non-sellers:** The second class consists of people who ***already owned*** shares in the issuer, who claim that they ***decided not to sell*** their shares because the corporation or its insiders made an ***unduly optimistic representation*** or ***failed to disclose negative material.*** These shareholders are affected by the "purchaser or seller" rule, because although they previously bought the shares, they did not do so "in connection with" the misrepresentation or omission.

c. **Loss of value of investment:** Finally, there are shareholders and creditors who have suffered loss in the value of their shares or claims, due to insider trading by the corporation's officials. The "purchaser or seller" rule has some real bite in this situation.

Example: P has been a long-time shareholder of XYZ Corp. Prexy, the president of XYZ, learns that XYZ's vice president has been embezzling for a long time, and has brought the company to the brink of insolvency. Instead of making a public announcement of this fact, Prexy secretly sells his entire holdings in XYZ at $20 per share. XYZ then announces the embezzlement, and the stock sinks to $5. P will not have standing to directly recover damages in a private 10b-5 action, because of the "purchaser or seller" rule. This is true even though he can say, plausibly, that Prexy has unfairly pocketed profits (or at least avoided losses) that should have been available to all shareholders equally.

i. **Derivative action:** But here, P may be able to bring a ***derivative*** action against Prexy. For instance, if Prexy sold

some of his shares back to XYZ during the period of non-disclosure (making XYZ a "purchaser"), the derivative action can be brought. Similarly, if XYZ happened to sell some shares to the public or to some other insider (perhaps by means of issuance of stock options to employees) during the period of non-disclosure, it will be a "seller" and a derivative action may be brought in its behalf against Prexy. But if XYZ has neither bought nor sold during the period of Prexy's non-disclosure of the embezzlement, a derivative action will not be available under 10b-5, and thus neither disappointed stockholders nor the corporation will be able to recover from Prexy.

d. Options: Suppose that P is a person who neither bought nor sold stock in connection with D's misrepresentation or insider trading, but that P did buy or sell an ***option*** on the company's stock. Does P's purchase or sale of this option make him a "purchaser or seller" for 10b-5 purposes? The courts are ***split*** on this question.

4. Defendant doesn't have to buy or sell: Keep in mind that the "purchaser or seller" requirement for 10b-5 private actions applies ***only to the plaintiff***: it has never been required that the ***defendant*** be a buyer or a seller. Thus if an issuing company, or an insider at that company, makes an ***affirmative misrepresentation*** to the marketplace (e.g., an intentionally misleading press release), the company or the insider can be liable under 10b-5 even though it/he never bought or sold a share of stock. See *infra*, p. 300.

a. D buys or sells options: Also, a defendant who insider trades by purchasing an ***option*** on a security is expressly covered by federal insider-trading provisions. See §20(d) to the '34 Act, added in 1984, expressly bringing options traders within the scope of federal insider-trading prohibitions.

F. Trading "while in possession" of info, vs. trading "on the basis of" info: Until 2000, it was not clear just what the causal relationship had to be between D's *knowledge* of the inside

information and his *decision* to trade the stock. Was it enough for liability that D was merely ***"in possession"*** of the inside information at the time of the trade, or did the government (or P in a private suit) also have to prove that D in some sense ***"used"*** the information in making his decision to trade? For example, suppose that D knew the inside information, but could conclusively prove that his decision was based entirely on other (public) factors — could D still be liable? The question was given a mostly ***"yes"*** answer in 2000 by the SEC's adoption of an important new rule, Rule 10b-5-1.

1. **"Awareness" test:** 10b-5-1 for the most part makes life tougher for possessors of inside information. The Rule starts by stating an apparently pro-defendant principle that Rule 10b-5 prohibits trading "on the basis of" material nonpublic information. But the Rule then defines "on the basis of" to *mean* ***"was aware of"*** the information at the time of the purchase or sale. In other words (except for a "safe harbor" which we'll discuss below), the government or private plaintiff merely has to show that D was ***"aware"*** of the inside information at the time he traded, *not* that the inside information in any sense ***caused or even affected*** D's decision to trade.

   a. **Safe harbor for preplanned trading:** But Rule 10b-5-1 also gives the insider an important ***"safe harbor"***: if before becoming aware of the inside information, the insider adopts a ***"written plan for trading securities"*** that ***locks the insider into making particular types of purchases or sales at particular times*** or under particular circumstances, sales that are made according to this preplanned trading arrangement won't be deemed to be "on the basis of" the inside information, even if the insider knows the information at the time the trade actually occurs. Cf. Hamilton (8th), p. 1053, n. 6.

      Example: Prexy, the head of XYZ Corp., owns $100 million of XYZ stock, and would like to gradually diminish the proportion that XYZ stock constitutes of his net worth. In late 2011, therefore, Prexy enters into an irrevocable written

contract with Broker, under which Prexy instructs Broker to sell $5 million of Prexy's XYZ stock during the first week of each calendar quarter for the next three years. On June 25, 2012, Prexy learns that XYZ will soon need to announce poor quarterly earnings, which will likely lead to a decline in the stock. On July 2, before the poor earnings are reported, Broker sells $5 million of stock for Prexy.

Even though the sale took place at a time when Prexy was in possession of material nonpublic information, Prexy has not committed insider trading, because he has successfully used the preplanned-trading-arrangement safe harbor of Rule 10b-5-1. That is, Prexy has (in the language of the safe harbor provision) "entered into a binding contract to purchase or sell the security," has "provided a written formula or algorithm … for determining amounts, prices and dates," and has shown that the sale was "pursuant to the prior contract." The idea is that because in late 2011 Prexy irrevocably made the decision to sell shares in the first week of July, 2012 — a decision that would bind him no matter what happened to the market price or status of XYZ — he won't be deemed to have sold "on the basis of" information that he didn't acquire until after making that irrevocable decision.

G. Requirement of misstatement or omission (including trading on material non-public information): The defendant must be shown to have made a ***misstatement*** or ***omission*** of a ***material fact***, in ***violation of some duty***.

1. **Affirmative misrepresentation:** If the plaintiff's claim is that the defendant has made an affirmative ***misrepresentation*** or told a ***half-truth***, the main impact of this requirement is that the plaintiff must show that the misstatement was ***"material."*** We discuss the meaning of "material" below.

2. **"Silent" insider trading:** In the case of garden-variety "silent" insider trading, the "misrepresentation or omission of a material fact" requirement means that the plaintiff must show not only that the defendant insider failed to disclose a material fact, but that he had a ***duty*** to make that disclosure. In general, this means

that the plaintiff must show that the defendant ***bought*** or ***sold*** while in possession of the material non-public information, or that he knowingly gave a ***tip*** to someone else in order to allow the "tippee" to buy or sell.

a. "Disclose or abstain" rule: In other words, the fact that the defendant was an insider who had material non-public information and failed to disclose it is never, ***by itself***, enough to expose him to a 10b-5 action. The rule is one of ***"disclose or abstain"***; the defendant must either: (1) disclose the information or (2) abstain from trading and from tipping others to allow them to trade. See the discussion of the *Texas Gulf Sulphur* litigation *supra*, p. 265.

3. Meaning of "material": The misrepresentation or omission must be as to a ***"material"*** fact. In a 10b-5 suit, a fact is material "if there is a ***substantial likelihood*** that a ***reasonable shareholder*** would consider it ***important***" in deciding whether to buy, hold, or sell the stock. ***Basic, Inc. v. Levinson***, 485 U.S. 224 (1988). Or, to put it a slightly different way, an omitted fact is "material" if there is a "substantial likelihood that the disclosure … would have been viewed by the reasonable investor as having significantly altered the ***'total mix'*** of information made available." *Id.* (This definition of "material" is the same as, and derived from, the definition of "material" for purposes of proxy materials, adopted in *TSC Industries, Inc.*, *supra*, p. 105.)

a. Application to mergers: One situation in which the precise definition of "material" is likely to be important, is where an insider buys the company's stock at a time when secret ***merger negotiations*** are under way. If the company and its suitor have ***not yet agreed on price or important terms*** (and, indeed, if the company has not yet even agreed in the abstract that it is for sale), is the mere fact that a suitor is attempting to buy the company automatically "material"? In *Basic, Inc. v. Levinson*, the Court held that the answer is ***"not necessarily."***

i. Balancing: Where an event may (but will not necessarily) occur, materiality "will depend … upon a ***balancing*** of both

the indicated ***probability*** that the event will occur and the anticipated ***magnitude*** of the event in light of the totality of the company activity." (Opinion in *Basic*, quoting from *SEC v. Texas Gulf Sulphur Co.*)

ii. Mergers: In the case of merger and acquisition discussions, the buy-out of the target company is the most significant event in that company's existence. Therefore, the possibility of that event becomes "material" at an ***earlier stage*** than where the event is a less important one (e.g., a rise in quarterly profits).

iii. Fact-based: In any event, the Court indicated in *Basic*, whether a particular set of merger negotiations has firmed up to the point of being "material" will be highly dependent upon the ***particular facts***, including such facts as whether the board has passed a resolution authorizing the company to conduct the discussions, whether investment bankers have been brought in, whether the principals have directly held negotiations, etc. (The issue is so fact-based that in *Basic* itself, the Court declined to decide whether the merger discussions there were "material," and instead remanded to the trial court on this issue.)

b. Fact need not be outcome-determinative: A fact does ***not*** have to be one that (if known to the investor) would have ***changed the investor's decision,*** in order to be "material." As one lower court has explained the significance of the Supreme Court's *Basic* "total mix" standard, "a material fact is one that would ***affect*** a reasonable investor's ***deliberations*** without necessarily ***changing*** her ultimate investment decision." *Folger Adam Co. v. PMI Industries, Inc.*, 938 F.2d 1529 (2d Cir. 1991).

4. Non-public fact: Where the wrong by the defendant is an ***omission*** rather than a misrepresentation, the omission must be of a fact that is ***non-public***. The main significance of this requirement is that an insider may not trade until the previously-undisclosed fact has been ***disseminated to the market at large***.

a. **Press release:** For instance, an insider may not buy a large block of XYZ stock one minute after XYZ's press release has been sent to the media, because the public at large has not yet had a chance to learn the news and act upon it; instead, the insider must wait until the media have disseminated the information. Thus in the *Texas Gulf Sulphur* litigation (*supra*, p. 265), the appeals court treated the news of the mineral strike as not becoming "public" until the story had been carried on the Dow Jones "broad tape," where a majority of investors could be expected to have learned of it; a trader who bought after Dow Jones and other news sources had been told of the strike, but before they had run the story, was held to have acted illegally.

H. **Defendant must be insider, knowing tippee or misappropriator:** In the case of silent insider trading, the defendant will not be liable in a private 10b-5 action unless he was either an ***insider,*** a ***"tippee"*** or a ***"misappropriator."*** In other words, merely trading while in possession of material non-public information is ***not by itself enough*** to make D civilly liable for insider trading under 10b-5.

1. **Violation of duty:** The key rule is that the duty to "disclose or abstain" only applies to ***"insiders," "tippees,"*** or ***"misappropriators***." A person who is none of these simply has no duty to disclose-or-abstain.

2. ***Chiarella*** **case:** This main parts of this rule — that a person who trades on material non-public information is not liable unless he is an insider or tippee — were established most dramatically in ***Chiarella v. U.S.***, 445 U.S. 222 (1980).

a. **Facts:** In *Chiarella*, D was a printer at Pandick Press, a financial printing company. Pandick received financial documents in connection with takeovers. The documents disclosed all the terms of the soon-to-be-launched takeovers, but the names of the suitor and target were left blank or replaced by phony names until the night of the final printing. D was able to deduce the identity of some of the targets by

other information in the documents, and secretly used this information to buy shares in the targets. He was charged with violating Rule 10b-5.

b. Holding: The Supreme Court held that D had not violated 10b-5, because he had not been under any duty to "disclose or abstain [from trading]". The duty to disclose or abstain only applied where there was a "***relationship of trust and confidence*** between parties to a transaction." Here, D had no direct fiduciary relationship with the target companies whose shares he traded in. Therefore, the mere fact that he traded while in possession of material non-public information was not enough to make him a violator of 10b-5.

i. Misappropriation: The prosecution argued that D had violated a duty ***to his employer*** (Pandick Press), by "stealing" the partially identifying information contained in the takeover document. The Supreme Court did not reject this "misappropriation" theory on the merits, but the Court ignored the theory because it had not been presented to the jury at D's trial.

c. Dissent: Chief Justice Burger, in a dissent, argued that the Court should accept the prosecution's "misappropriation" theory: "A person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading." Since D used information entrusted to him in confidence (the identifying clues in the tender offer documents), he was guilty of misappropriation, and should be found to have violated 10b-5, Burger argued.[3]

d. Significance of *Chiarella:* *Chiarella* establishes the principle, which remains in force, that the mere trading on non-public information does not by itself violate 10b-5, and that there can be a 10b-5 violation only when the person has violated, or knowingly benefited from another's violation of, a fiduciary duty. But *Chiarella* itself would almost certainly be decided differently today.

i. Mail or wire fraud: First, D could almost certainly be

convicted of ***wire fraud*** or ***mail fraud*** for having misappropriated the information entrusted by the acquirers to Pandick and thence to him. See the discussion of *U.S. v. Carpenter, infra*, p. 290.

ii. 10b-5: Second, the Supreme Court has finally accepted the misappropriation theory urged by Chief Justice Burger in *Chiarella.* See *U.S. v. O'Hagan, infra*, p. 291. Thus today, a person who improperly uses confidential information from one other than the issuer (e.g., from a company that is planning a tender offeror for the issuer), can be liable under 10b-5. Therefore, it is highly likely that if the Supreme Court were hearing the case today, it would hold that *Chiarella did* violate 10b-5, by ***misappropriating information entrusted to him by his employer.***

iii. Consequence: Therefore, the only situation in which the non-liability rule of *Chiarella* clearly applies is where the trader has learned the information ***without any breach of fiduciary responsibility by anyone.*** For instance, if *Chiarella* had learned the information by ***overhearing*** a chance remark in a restaurant or finding a slip of paper on the sidewalk, he would not be liable under 10b-5 even under the most expansive reading of later cases. See the discussion of this "inadvertent discovery" situation *infra*, p. 288.

3. Meaning of "insider": An "insider" will be liable under 10b-5 if he trades while in possession of material non-public information. What, then, is an ***"insider"***? The Supreme Court has never given a precise definition, but the concept seems to be that an insider is one who obtains information ***by virtue of his employment with the company*** whose stock he trades in.

a. High-level employees: Thus ***officers, directors and high-level employees*** of a company are clearly "insiders," and are liable under 10b-5 if they trade in the company's stock while in possession of material non-public information about the company.

b. **Lower-level employees:** Furthermore, even a low-level employee who ***learns information by virtue of his employment*** with the company is an "insider."

Example: David is a secretary for Prexy, the president of XYZ Corp. One day, while David is straightening up Prexy's desk, David notices a letter from Suitor to Prexy, saying "We propose to acquire XYZ for $20 per share." David goes out and buys XYZ stock at $10 a share. David is almost certainly an "insider," and has thus violated 10b5 even though he is a low-level employee. He has gotten the inside information by virtue of his employment by XYZ, and has a fiduciary responsibility to keep that information confidential and to not use it for his own purposes. (For instance, he is probably liable for misappropriation of company property under state law; see, e.g., *Diamond v. Oreamuno, supra*, p. 261; Clark, p. 323.)

c. **"Constructive" insider:** People who do not work for the issuing company, but who are ***entrusted*** by it with confidential information, probably also become ***"constructive"*** insiders. For instance, if XYZ gives one of its outside ***professionals*** (e.g., its lawyer, accountant or investment banker) information about XYZ so that the professional can perform a service for XYZ, the professional is almost certainly a constructive insider, and may not trade on the information without violating 10b-5. This topic is discussed further *infra*, p. 288.

4. **Liability of "tippee":** The main other type of person who violates 10b-5 if he trades on inside information is the ***"tippee."*** A tippee is a person who is not himself an insider, but to whom an insider consciously gives inside information. Clark, p. 324. The most important thing to remember about tippee liability under 10b-5 is that this liability is ***derivative*** from the liability of the tipper — unless the insider/tipper has ***consciously violated his fiduciary responsibility*** to the company for personal gain, the ***tippee has no liability*** even if he trades on the information for his own gain. This is the core holding of the landmark case of ***Dirks v. Securities & Exchange Commission***, 463 U.S. 646 (1983).

a. **Nomenclature:** Before we get into the facts of *Dirks*, let's review some nomenclature. A "tipper" is one who gives inside information to another. A "tippee" is one who receives insider information from an insider. A "secondary tippee" is one who receives inside information from a tippee. In the case of secondary tipping, a person can be both a tipper and a tippee.

   Example: Able, the president of XYZ Corp., is of course an insider with respect to the news that XYZ has just made a major new mineral discovery. If Able tells Baker, a friend not employed by XYZ, about this news, Able is a tipper and Baker is a tippee. If Baker now tells his cousin Carr about this news, Baker is both a tipper and a tippee, and Carr is a secondary tippee.

b. **Facts of *Dirks:*** Ray Dirks was a securities analyst who specialized in insurance stocks. He received a call from Ronald Secrist, a former officer of Equity Funding Corp., a company that sold life insurance and mutual funds. Secrist claimed that Equity Funding's assets had been vastly overstated through various fraudulent practices (e.g., phony life insurance policies). Dirks then investigated by interviewing various officers and employees of Equity; senior officials refused to corroborate the charges but lower employees did so. Dirks tried to get the *Wall Street Journal* to publish a story on the fraud, but it declined to do so. Although Dirks and his firm did not trade in Equity Funding stock during his investigation, Dirks told some of his investor customers about his findings, and they sold Equity Funding stock. Eventually, due mostly to spreading rumors about Secrist's charges, the stock price collapsed, trading was halted, and the fraud was exposed. The SEC charged Dirks with a violation of 10b-5, on the theory that the fraud allegations were inside information that Dirks gave to his clients for the purpose of permitting them to trade in Equity Funding stock.

c. **Holding:** The Supreme Court held that Dirks ***did not violate*** 10b-5. Dirks was clearly a tippee, not an insider. As such, any liability he might have for misusing the inside information

must ***derive*** from the liability of his tipper (in this case, Secrist). "[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the ***insider has breached his fiduciary duty*** to the shareholders by disclosing the information to the tippee and the tippee ***knows or should know*** that there has been a breach."

i. **Secrist's non-liability:** So the question became whether *Secrist*, by passing on to Dirks information about the fraud, had himself violated his fiduciary obligation to Equity. Here, the Court held, there was no breach merely by virtue of the fact that Secrist passed on insider information; instead, an insider breaches his fiduciary duty to the corporation only if he ***"personally will benefit, directly or indirectly from his disclosure."*** Such a benefit might occur if the insider received some direct ***monetary*** or other ***personal benefit***, or if the insider was intending to ***make a gift*** of the confidential information (e.g., a gift to a relative or friend).

ii. **Application to facts:** But here, neither Secrist nor the other low-level employees who corroborated his charges received any monetary or personal benefit from Dirks, nor did they intend to make him a gift. Therefore, these insiders did not breach any fiduciary obligation. Therefore, Dirks had ***no derivative liability*** as tippee, and thus did not violate Rule 10b-5.

d. **Dissent:** Three dissenters in Dirks conceded that the tippee's liability should derive from the tipper's liability. But they believed that the tipper breaches a fiduciary responsibility to his company and its shareholders whenever he ***knowingly harms*** the shareholders, regardless of whether he is attempting to get a personal benefit. Here, Secrist knew that he would be harming Equity Funding shareholders (by disclosing damaging information which would drive down the stock's price); therefore, the fact that he received no personal gain should be irrelevant. Since Secrist violated his obligation of

confidentiality to the shareholders, Dirks should have derivative 10b-5 liability, the dissenters contended.

e. Consequence: So *Dirks*' main importance is that it establishes that: (1) a tippee is liable under 10b-5 ***only if his tipper*** (the insider) has ***violated some fiduciary duty to the company*** or its shareholders; and (2) the insider/tipper violates a fiduciary duty only where he receives a direct ***"benefit"*** from disclosing the information, or intends to give something of pecuniary value to the tippee. Where the insider acts for some "altruistic" purpose (e.g., exposing fraud), his tippee cannot be liable under 10b-5 even if the tippee uses the information for his own direct personal benefit. (For instance, even if Dirks had bought Equity Funding stock himself, and reaped huge profits, under the majority's analysis he would not have been liable.)

f. Additional discussion: We discuss additional aspects of tippee liability — including when the insider/tipper receives a "benefit" — *infra*, p. 286.

I. Requirement of scienter: A defendant will be liable under 10b-5 only if he acted with ***scienter***, that is, with an intent to ***deceive, manipulate or defraud***. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

1. Significance: This requirement of scienter has historically been important where the defendant was a ***professional firm*** (e.g., an accounting or law firm) charged with ***aiding and abetting*** a 10b-5 violation. Unless the plaintiff could show that the professional firm's conduct amounted to something worse than negligence, the firm would not be liable under 10b-5 despite its sloppiness.

2. Facts: Thus in *Ernst & Ernst* itself, defendants were a Big Eight accounting firm that had audited the books of First Securities Co., a small brokerage firm. First Securities' president had been carrying on a massive fraud for years, converting customers' accounts to his own use. The accounting firm missed a number of clues to the fraud (e.g., the fact that the president insisted on being the only one to open certain kinds of mail), yet

there was no suggestion that the accounting firm ever intended to defraud or mislead those who relied on its audit.

3. **Holding:** A majority of the Court held that a showing of scienter was necessary in any 10b-5 action (at least any private action for damages).[4] The court relied heavily on the use of the word “manipulative,” “device,” and “contrivance” in §10(b) of the ’34 Act (under the authority of which the SEC has enacted 10b-5). These terms, the court held, connote “intentional or wilful conduct designed to deceive or defraud.…”

4. **What scienter means:** What exactly does “scienter” mean? As the Court says in *Ernst & Ernst*, the essential concept is an intent to “deceive, manipulate, or defraud.” But even this phrase is somewhat vague.

   a. **Knowing falsehood:** Clearly if D misstates a material fact ***knowing*** that the statement is false, and with the intent that the listener rely on the misstatement, scienter is present.

   b. **Absence of belief:** Additionally, if the representation is made ***without any belief as to whether it is true or not***, this almost certainly constitutes scienter as well. See C&E, p. 930.

   c. **False statement of knowledge:** Similarly, if D states that he knows a fact to be true, when in fact D knows that he does not really know whether the fact is true or not, this is almost certainly scienter: D has intentionally defrauded his listener “not so much as to the fact itself, but rather as to the extent of [the speaker’s] information.” Prosser & Keeton on Torts, p. 742.

   d. **Recklessness:** Virtually all courts post-*Ernst* have concluded that if the defendant makes a misstatement ***recklessly***, he has scienter. C&E, p. 931.

      i. **Affirmative misstatement:** In the case of an affirmative misstatement, a person who makes the misstatement with total disregard whether it is true or false has acted recklessly.

      ii. **Omission:** Where the claim is that the defendant has

failed to act or speak, rather than that the defendant has made a misstatement, the definition of "recklessness" for 10b-5 purposes is less clear. Most courts would probably agree that where the defendant has ***ignored a danger*** that is so obvious that any reasonable man would have known of it, he has acted recklessly (even if the defendant in fact did not know of the danger). Thus on the facts of *Ernst & Ernst*, if the clues to fraud were so blatant that any reasonable accounting firm would have picked up on the fraud, the Ds' silence would constitute recklessness and thus scienter even if there is no explicit proof that the Ds had actual knowledge of the fraud.

5. **Insider trading:** Is there any practical impact of the scienter requirement on 10b-5 violations involving garden variety "silent" insider trading? The main impact of the scienter requirement here is that "the defendant must have ***known*** that the information to which he had access while trading was ***material*** and ***nonpublic***." Clark, p. 328. For instance, if D honestly (even if somewhat unreasonably) believes that the news of his company's mineral strike has ***already been released*** to the public, his purchase of shares in the company would not be a violation of 10b-5.

   a. **Failure to control another person's insider trading:** But there is one situation in which a defendant who is ***without scienter*** may nonetheless be liable for insider trading. Under the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), the SEC may obtain large civil penalties against D if D ***"controlled"*** X, an insider trader, and D "knew or recklessly disregarded the fact that [X] was likely to engage in the act or acts constituting the violation and ***failed to take proper steps to prevent such act or acts*** before they occurred." §21A(b)(1)(A) of the '34 Act. So an issuer, law firm, accounting firm, investment banking firm, etc. can be liable even without scienter if it ***knew of or recklessly disregarded the chance that its employees might insider-trade,*** and ***failed to institute safeguards*** (e.g., warnings, and the walling-off of

information from those without the need to know it) to prevent insider trading. See the further discussion of ITSFEA *infra*, p. 283.

6. **Pleading of scienter:** In the case of private class-action suits for 10b-5 violations, the plaintiff(s) must ***plead*** the facts relating to scienter ***"with particularity."*** See *infra*, p. 304.

J. Actual causation, reliance: The plaintiff in a 10b-5 private damage action must show that his harm was ***caused in fact*** by the defendant's wrongdoing. In other words, P must show that ***but for D's wrongdoing***, P would not have been injured. Sometimes, courts say that to prove causation, P must show that he ***relied*** on D in some way. (But as we'll see, this reliance need not always be shown.)

1. **Common law requires reliance:** In common-law deceit actions, "causation in fact" must be proven by showing that P ***relied*** on D's misrepresentation. Thus suppose D says to P, "This house I'm offering to sell you does not have termites," and P knows through an independent inspection that the house does have termites. If P buys the house anyway, he will not be able to sue D for deceit: he did not rely on D's misstatement, so even if the house falls apart due to termite damage P's loss has not been caused in fact by D's misstatement.

2. **Reliance under 10b-5:** In 10b-5 cases, most courts similarly assert that P must show that he relied on D's wrongdoing. But in 10b-5 cases, unlike the typical common-law face-to-face deceit situation, P can be hurt by D's misrepresentations or insider trading without having directly relied on D's conduct. (We'll see how in a moment.) Therefore, the frequently-asserted requirement of reliance in 10b-5 cases can be better understood as a more general requirement that P show that his losses were ***caused in fact*** by D's misconduct (i.e., would not have occurred without that misconduct).

3. **"Fraud on the market" theory:** The most important way in which P can show that he was harmed by D's misconduct even though he did not rely on anything D did or said, is by use of the

"fraud on the market" theory. P makes an argument that goes something like this: "The Efficient Capital Markets Theory (*supra*, p. 253) says that at any time, the price of any stock reflects all publicly-available information. When I purchased (or sold) stock in XYZ Corp., I relied on the current market price being a 'fair' one that reflected all known information. When D made a misstatement to the public about XYZ's prospects (or when D bought/sold XYZ stock secretly without complying with his duty to disclose material non-public information), his wrongdoing made the price different from what it would have been had he fulfilled his obligations. Therefore, when I bought/sold based on the market price, I paid more/received less because of D's wrongdoing, and my economic loss was caused in fact by that wrongdoing."

a. Accepted in *Basic* case: The Supreme Court essentially accepted this "fraud on the market" theory, and consequently gave the plaintiff the benefit of a ***presumption of reliance*** on the defendant's misleading statements, in ***Basic, Inc. v. Levinson***, 485 U.S. 224 (1988).

i. Facts: *Basic*, *Inc* was a case involving an alleged ***affirmative misrepresentation***. D (Basic, Inc.) was involved in merger discussions with another company, Combustion Engineering. Yet it publicly denied that any merger discussions were under way, and denied knowing of any other reason why the company's stock was trading heavily and setting new highs. A buyout of D was finally announced, and shareholders who had sold prior to the buyout announcement at less than the final buyout price brought a class action. The Ps claimed that they were injured by having sold shares in D at "artificially depressed prices" in a market that had been affected by D's misleading statements.

ii. "Fraud on market" theory accepted: The Court first reiterated that reliance is an element of a 10b-5 claim. However, the Court gave Ps the benefit of a ***rebuttable presumption of reliance***: instead of requiring each P to

prove that he personally knew of D's misstatements and relied on them in making his decision to sell the stock, the Court would presume that: (1) the price of D's stock at any time reflected everything that was publicly known about D's prospects; and (2) therefore, the price each P received was affected by any material misrepresentations made to the public by D (i.e., by any "fraud on the market" perpetrated by D).

iii. Rebuttable: But the Court also stressed that this presumption is ***rebuttable***. In other words, if the defendants could show that the misrepresentation did not affect the market price, or that the particular plaintiff in fact did not rely on the "integrity" of the market price, the presumption would be rebutted (and presumably plaintiff would lose). For instance, if the defendants could show that the market was ***aware*** that the defendants were ***lying*** (so that the market price was not affected by their lies), the presumption would be rebutted; similarly, if the defendant can show that a particular plaintiff disbelieved the defendant's lies but sold anyway, the presumption would also be rebutted.

iv. Dissent: Two justices ***dissented*** from the majority's use of a presumption of reliance based on the "fraud on the market" theory. Most fundamentally, they objected on empirical grounds to the proposition that an investor typically relies on the "integrity" of the market price. The very point of investing in stocks, they argued, is to buy when the price is less than the stock is really worth and sell when it is more than the stock is really worth, a technique that is at odds with reliance on the integrity (in the sense of accuracy) of the market price.

b. Insider trading cases: The "fraud on the market" theory, and the consequent presumption of reliance, are clearly important in those 10b-5 cases that involve *affirmative misrepresentations*. (The defendant's false denials of merger discussions in *Basic, Inc.* are one example.) But in the usual insider trading case, there is no representation (false or

otherwise) being made by the defendant. Instead, he is simply ***silently trading***. Here, the whole requirement of reliance is really ***meaningless***: it doesn't make any sense to say that P relied on a fact that D was obligated to disclose but did not disclose. C&E, p. 868. Therefore, the "fraud on the market" theory is probably irrelevant in this typical "silent" insider trading context.

i. Causation: Instead, the real question in these "silent" cases is ***causation***, not reliance: "[O]nce the plaintiff has shown that defendant omitted to disclose a material fact he was obliged to disclose, the burden is on the defendant to prove that the plaintiff would have made the same investment decision even if disclosure had been made." C&E, p. 869. (Remember that even in affirmative misrepresentation cases, reliance is really just one way of showing that the defendant's misstatement was the "cause in fact" of the plaintiff's damages.)

K. Proximate cause: In theory, there should also be a ***proximate cause*** requirement in 10b-5 cases. That is, under normal tort principles P should have to prove that his loss was the ***reasonably foreseeable consequence*** of D's misconduct. Clark, p. 337. But this requirement of proximate cause seems to have little practical impact in 10b-5 cases.

1. Need not be in privity: For instance, courts could have, but clearly have not, used the proximate cause requirement to impose a requirement of ***privity*** on the plaintiff. In other words, if D engages in insider trading or tells lies about the company, P can win ***without showing that he traded directly with D***.

2. Misrepresentation: In the case of a misrepresentation or half-truth told by D, the proximate cause requirement seems displaced by notions of the efficient market and the "fraud on the market" theory. Since D's lies (at least when they are on a material matter and are believed by some traders) affect the price of the stock, those lies not only are the cause in fact of the damage to any plaintiff who buys at a higher price (or sells at a

lower price) than he otherwise would have gotten, but these lies are also the proximate cause (i.e., reasonably foreseeable cause) of P's damages.

3. **Insider trading:** In the garden-variety "silent" insider trading context, proximate cause similarly seems not to be required by courts. If the insider buys while concealing good news (or sells while concealing bad news), courts seem to say, implicitly, "It is reasonably foreseeable that had D made disclosure instead of concealing his inside information, anyone who traded in the market thereafter, including P, would have gotten a better price."

   a. **ITSFEA:** The irrelevance of proximate cause in ordinary insider trading cases also seems to be embodied in a federal statute. As part of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Congress added §20A to the '34 Act, which gives those who buy or sell during the time of insider trading a private right of action against the insider trader. §20A does not say anything about causation, and seems to assume (as courts have done) that where P and D are trading on opposite sides at the same time, D's insider trading has proximately caused P's losses. See the further discussion of ITSFEA *infra*, p. 283.

L. Aiding and abetting: Suppose that a violation of 10b-5 is principally engineered by A, but that a second person, B, helps him commit the violation. Can B be civilly liable for ***"aiding and abetting"*** this 10b-5 violation? As the result of a 1994 Supreme Court case, the clear answer is now "***no.***"

1. ***Central Bank of Denver*** **case:** That 1994 decision was ***Central Bank of Denver v. First Interstate Bank of Denver***, 511 U.S. 164 (1994).

   a. **Facts:** In *Central Bank*, D was a bank that served as trustee for certain public housing bonds. The Ps (bond holders who lost money when the issuer defaulted) claimed that D had had suspicions that the issuer of the bonds was misrepresenting its financial situation, but that D delayed an independent review of that financial situation until after the issuer's default. Thus,

the Ps claimed, D was liable under 10b-5 for aiding and abetting a misrepresentation, even though D itself never made any misrepresentation.

b. Holding: But the Supreme Court, by a 5-4 vote, held that ***there can be no "aiding and abetting" liability*** under 10b-5. The majority reasoned that the plain text of the statute prohibits only the making of a material statement or omission or the commission of a manipulative act, and that this language simply does not extend to cover a person who merely helps another person commit such a statement or act. Nor did the majority believe that Congress would have created a private right of action against aiders and abetters had it thought about the subject.

2. Suits against professionals: *Central Bank of Denver* means that 10b-5 suits against ***professionals*** (the group against whom aider-and-abetter suits were most often brought) are now ***harder to bring***. But they are not impossible — professionals can still be sued when they make a misrepresentation (or, more likely, an omission). In other words, they can still be ***"primarily"*** liable even though not "secondarily" liable.

Example: Suppose that ABC Partners, an accounting firm, certifies a company's financial statement while knowing that (or recklessly disregarding the risk that) the numbers are wrong. In this situation, ABC can probably be held liable, not as an aider-and-abetter, but as the actual "maker" of an material omission. (In this situation, the requirement of "scienter," see *supra*, p. 268, will be important.)

3. SEC enforcement authority: Although *Central Bank* establishes that private plaintiffs can't recover on an aider-and-abetter theory, the ***SEC*** now has authority to sue for an ***injunction*** against the aiding and abetting of securities fraud. Congress expressly gave the SEC this power, in a 1995 statute enacted in response to *Central Bank*.

4. Tipper's liability: Before *Central Bank*, plaintiffs often used an aider-and-abetter theory to sue the ***tipper*** in insider-trading

cases, even where the tipper did not benefit directly from the insider-trading, and did not himself buy or sell securities. *Central Bank* makes this no longer possible.

a. **Explicit private action against tipper:** But an aider-and-abetter theory is not really necessary to reach such a tipper. That's because §20A(c), added to the '34 Act in 1988, gives a buyer or seller an ***express private right of action*** against the tipper: "Any person who violates any provision of this Title or the rules or regulations thereunder by ***communicating*** material, nonpublic information shall be jointly and severally liable … with, and to the same extent as, any person or persons liable under subsection (a) [giving a private right of action against the person who actually trades based on the inside information] to whom the communication was directed."

M. The Insider Trading and Securities Fraud Enforcement Act of 1988: Congress broadened and intensified the fight against insider trading with the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). Here are some highlights of ITSFEA:

1. **Express private right of action:** Recall (see *supra*, p. 264) that neither §10(b) of the '34 Act, nor the SEC's rule 10b-5, expressly allows a private person who has bought or sold stock to bring a civil damages action against an insider-trader. But ITSFEA for the first time added into the '34 Act an ***express private right of action.*** Under §20A:

> "***[A]ny person who violates*** any provision of this Title or of the rules or regulations thereunder by ***purchasing or selling a security while in possession of material, nonpublic information*** shall be ***liable in an action*** in any court of competent jurisdiction ***to any person*** who, ***contemporaneously*** with the purchase or sale of securities that is the subject of such violation, has ***purchased*** (where such violation is based on a sale of securities) or ***sold*** (where such violation is based on a purchase of securities) securities of the same class."

So if P is, say, buying shares in XYZ Corp at the same time D, an insider, is dumping them based on his own knowledge that XYZ's prospects are less good than the market believes, P now has an express statutory right to recover civil damages from D.

a. **Does not define "insider trading":** Neither §20A nor any other part of ITSFEA attempts to ***define*** "insider trading," or to determine who is an "insider," or to determine what is "material nonpublic information." It is left to the courts to decide these questions, just as it has always been. All §20A does is to make it clear that once P has convinced the court that D has insider-traded, P is permitted to recover damages. (Section 20A also places some limits on damages, and makes the tipper liable, as discussed below.)

b. **"Contemporaneous trader" requirement:** Section 20A(a) gives a right of action only to one who is a ***"contemporaneous trader."*** That is, P must show that at about the ***same time*** D was doing his insider trades, P was trading in the ***opposite direction***, though not necessarily directly with D. Thus P must have been buying at about the time D was selling, or vice versa.

c. **Person who is not "contemporaneous trader":** But even people who are ***not*** "contemporaneous traders" may be injured by insider trading. As to these people, §20A does not affect their remedies, and they may still be able to persuade a court to allow an implied private right of action.

   i. **Would-be acquirer:** For instance, a would-be ***acquirer*** may be able to obtain civil damages against an insider trader, even though the acquirer had not yet begun to buy up the target stock (but later had to do so at a higher price, because of an increased price triggered by the insider's purchases). See the fuller discussion of recovery by an acquirer *infra*, p. 292.

2. **Liability of tipper:** ITSFEA makes it clear that the ***tipper*** will be liable to the same extent as the tippee, even if the tipper did not benefit financially from the tip. See §20A(c), discussed further *supra*, p. 282.

3. **Controlling person:** ITSFEA lets the SEC obtain substantial ***civil damages*** against a ***"controlling person"*** when the "***controlled*** person" commits insider trading. Under §21A(a)(1)

(B), the SEC may obtain a "civil penalty to be paid by a person who, at the time of the violation, directly or indirectly controlled the person who committed such violation." However, the SEC must show that the controlling person "***knew*** or ***recklessly disregarded*** the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before the occurred.…" §21A(b)(1)(A).

a. **Extensive liability:** Under this provision, a ***law firm***, accounting firm, issuer, financial printer, newspaper, etc., could be liable for ***failing to take steps to guard against*** insider trading. The civil penalty can be "the greater of $1,000,000 or three times the amount of the profit gained or loss avoided as a result of such controlled person's violation."

   Example: X is an associate at Law Firm, in Law Firm's real estate department. X learns from Y, an associate in the firm's mergers and acquisitions department, that Raider, a client of Law Firm, will soon be launching a tender offer for the shares of Target Corp. Law Firm has never instructed Y or its other mergers-and-acquisitions lawyers not to discuss pending tender offers; nor has Law Firm enacted any written policy on insider trading. X insider trades, buying Target Corp stock at $20, which he is able to sell for $40 once Raider's $42-per-share tender offer is announced. A court might well find that Law Firm, as the "controlling person" of X, knew of or recklessly disregarded the chance that X or some other lawyer at the firm would insider trade, and neglected to take "appropriate steps" to prevent such insider trading. If the court so found, the SEC could recover from Law Firm penalties equal to the ***greater*** of $1 million or three times the profit gained by X.

4. **Bounty:** ITSFEA allows a person to receive a ***bounty*** for turning in an insider-trader. Under §21A(e), the informant may receive a bounty of up to 10% of the civil penalties received by the SEC stemming from the tip.

N. Damages: Suppose that the plaintiff in a civil 10b-5 suit does jump through all of the hoops required for a successful action. What then is the ***measure of damages*** for P's recovery? The answer depends on a number of factors, most importantly whether D has made misrepresentations or has merely silently traded based on insider information.

1. Misrepresentation by D: Where the defendant has made a ***misrepresentation*** either to the public at large or directly to P, most courts seem to award P a measure of damages based upon what would be needed to ***put him in the position he would have been in had his trade been delayed until after the misrepresentation was corrected.*** Thus in the case of a plaintiff who sells in response to the defendant's falsely pessimistic statement, P will usually get the difference between what he actually received and what he would have received had he sold when the misstatement was shown to be false. A converse rule would be followed for the plaintiff who bought upon a false optimistic statement by D.

2. D is silent insider-trader: Where D is a ***silent insider-trader*** rather than a misrepresenter, the damage issue is somewhat trickier. First, there is no clearly-applicable "moment of wrongdoing": whereas in the misrepresentation case, the moment of the wrong is the moment the misrepresentation takes place, in the insider trading context it is not clear whether the time of wrongdoing is the time of trading or the (possibly long) period of nondisclosure before or after the trading. Also, causation in fact is much more difficult to determine in the insider trading context (see *supra*, p. 279), leading courts to be leery of using an unduly broad measure of damages.

a. Limited liability under ITSFEA: Recall (see *supra*, p. 283) that a ***"contemporaneous trader"*** may sue the insider trader or tipper in an express private right of action now granted by §20A of the '34 Act (added by the Insider Trading and Securities Fraud Enforcement Act of 1988). Congress has defined the measure of damages in such private actions relatively ***narrowly***. Under §20A(b)(1), the total damages that

may be recovered from the defendant in a §20A action "shall not exceed the ***profit gained or loss avoided*** in the transaction or transactions that are the subject of the violation." Furthermore, the damages are to be ***reduced*** by the amount of any ***disgorgement*** recovered from the defendant by the SEC. §20A(b)(2).

Example: Tipper, an insider at IBM, learns that IBM will shortly be announcing a sharp rise in quarterly profits. Tipper tells his friend, Tippee, about this news, with the intention of letting Tippee buy some shares cheaply. At a time when the market has no inkling that this improvement will occur, Tippee buys 100 shares of IBM at $120 per share. Two weeks later, the favorable earnings report is released, and the stock jumps to $140 per share. During the two week period between Tippee's trade and the final disclosure, Paul, a large investor, sells one million shares of IBM at an average price of $125; he would not have made this sale had he known of the rise in quarterly profits (the inside information).

Paul may sue Tippee and Tipper under the explicit private right of action given in §20A. But Paul's recovery is limited to $2,000 (the profits earned by Tippee). Furthermore, if the SEC obtained a disgorgement order against Tippee (as the SEC may do under §21A(a)(1)), Paul's recovery against Tippee would be further reduced by the amount of that disgorgement.

i. **Limit not applicable to other types of actions:** Section 20A(b)'s limitation-ofdamages provision applies ***only*** to actions brought by "contemporaneous traders." Other categories of people hurt by insider trading may have an implied private right of action, and if they do, it is up to the court to decide on the appropriate measure of damages. For instance, a would-be ***corporate acquirer*** probably has an implied right to recover damages against one who insider-trades in the target's stock and thereby drives up the price; if so, the acquirer might be permitted to recover damages in excess of the defendant's illegal gain; see the discussion of such suits by acquirers *infra*, p. 292.

3. Civil penalty by SEC: In addition to damages recoverable by a private plaintiff for insider trading, the ***SEC*** may also recover ***civil penalties*** against the insider-trader. Section 21A of the ’34 Act (added by ITSFEA in 1988) lets the SEC recover up to ***three times*** the profit gained or loss avoided by the insider trader. §21A(a)(2). This civil penalty may also be recovered against the ***tipper*** (even if the tipper did not benefit financially), so that the tipper can be required to pay three times the profits made by the tippee. Finally, anyone who “controls” a tipper or tippee and fails to take appropriate steps to prevent insider trading may be subject to civil penalties.

a. In addition to disgorgement: The insider trader may have to pay the civil penalty ***in addition*** to being required to “disgorge” his illegal gains.

IV. RULE 10b-5 — WHO IS AN “INSIDER,” “TIPPEE” OR “MISAPPROPRIATOR”?

A. Introduction: Recall that not everyone who trades based on material non-public information violates 10b-5 — only those traders who are found to be “insiders,” “tippees” or “misappropriators” are covered by 10b-5. In this section, we take a closer look at various classes of people to see whether they are “insiders,” “tippees” or “misappropriators,” or, instead, are ones who may trade with impunity despite their possession of material non-public information. As we go through the various categories, keep in mind the three central rules established in *Chiarella* (*supra*, p. 274), *Dirks* (*supra*, p. 276) and *O’Hagan* (*infra*, p. 291):

[1] a person is an ***“insider”*** only if he has some kind of ***fiduciary relationship*** that requires him to keep the non-public information confidential;

[2] a person is a ***“tippee”*** only if

(a) he receives information that is given to him in ***breach of the insider’s fiduciary responsibility***, *and*

(b) he ***knows*** that (or, perhaps, ***should know*** that) the breach

has occurred, *and*

(c) the insider/tipper has received some ***benefit*** from the breach (or intended to make a pecuniary gift to the tippee); and

[3] a person is a ***"misappropriator"*** if he is an ***"outsider"*** who gets the information from one other than the issuer, in violation of an express or implied ***promise of confidentiality***.

B. Who is a "tippee": Let's first look in a little more detail at the three requirements for a person to be a "tippee" for 10b-5 purposes.

1. Breach of insider's fiduciary responsibility: First, the tippee must receive the information from an "insider," and the disclosure must be ***in breach of the insider's fiduciary responsibility.*** This is the requirement that effectively makes the tippee's liability "derivative" from the tipper's liability.

Example: Driller works for Oil Co. Through Driller's job, Driller hears that an industry rival, Gas Co., has made a major find. Driller tells his friend Fred about this information, which is non-public. Fred buys Gas Co. stock. Assume that Driller is not an "insider" of Gas Co. (the issuer), nor has Driller's disclosure breached any fiduciary responsibility to Gas Co.[5] Therefore, Driller can't be liable for a 10b-5 violation, and consequently Fred (whose liability would have to be derivative from Driller's liability) can't be liable either.

2. Tippee's knowledge: Second, the tippee isn't liable unless he ***knows*** (or, perhaps, ***should know***) that the info being given to him is in violation of the tipper's fiduciary responsibility.

Example: Same facts as the prior example, except now assume that Driller learned about Gas Co.'s find as the result of a job interview at Gas Co., in which he was told (before he was given the info), "Don't tell this information to anyone outside the company — it's top secret." Also, assume that Driller merely divulged the info to Fred, without giving Fred any reason to believe that Driller had promised to keep the info secret. Even if *Driller* is liable for a 10b-5 violation (which he may well be, if he intended to confer a financial

benefit on Fred), *Fred* won't be liable, because he didn't know or have reason to know that Driller was violating a fiduciary responsibility.

3. **Benefit to tipper:** Finally, the tipp***er*** must have ***received some benefit*** from the breach, or at least have ***intended to make a pecuniary gift to the tippee***. This means that a mere "did you know …" comment by the tipper, made without thought as to the possibility that the tippee will trade on the info, probably doesn't trigger liability on the tippee's part.

   Example: Executive gets drunk in a bar, and says loudly to Bartender, "My Company, Gas Co., just struck oil in Malaysia, so I'll probably be going out there next week, and I won't see you for a while." It never occurs to Executive that Bartender might trade on the info, and Executive certainly doesn't intend to get any benefit for himself (or to confer any financial benefit on Bartender) by the remark. Bartender hears, buys, and profits. Bartender isn't liable under 10b-5, because Executive didn't intend to give him a benefit or obtain his own (direct or indirect) benefit from the disclosure. So even though Bartender's own conduct is completely venal (and, most people would say, should be barred by 10b-5), Bartender gets off the hook.[6]

   Note: But if the tipper *does* intend to help the tippee make money, it's no defense (either to the tipper or the tippee) that the tipper didn't intend to ***benefit himself***. Thus if Executive in the above Example said to Bartender, "Why don't you buy some options on Gas Co.," Executive and Bartender would both be liable under 10b-5, because Executive has intended to confer a financial benefit on Bartender. And that would be true even if it never occurred to Executive to benefit himself in any way (as by asking Bartender to kick back some of the profits to him).

C. **Information acquired by chance:** As a consequence of the first requirement above (breach of fiduciary responsibility by the tipper), if an outsider acquires information ***totally by chance***,

without anyone's violating any fiduciary obligation of confidentiality, the outsider may trade with impunity. For instance, this will be the case if the outsider, without breach of any fiduciary responsibility, randomly ***overhears*** the inside information, randomly sees a ***document*** containing the information, etc.

D. Information acquired by diligence: Similarly, if an outsider acquires non-public information through his own ***diligence***, he may trade upon it despite its non-public nature, so long as no one breached his own fiduciary responsibilities in passing the information on to the outsider. *Dirks* is itself the best illustration of this principle: Dirks ferreted out clearly non-public information about the fraud at Equity Funding, but since the people who told him about it were not violating any fiduciary duty of their own (because they received no personal financial benefit), Dirks never became a "tippee" and had no liability under 10b-5.

E. Intent to make a gift: If an insider gives an outsider information with the ***intent to make a gift*** of ***pecuniary value*** to the outsider, the outsider *will* be a "tippee," and ***both insider and outsider*** will be liable.

1. **No intent to make pecuniary gift:** On the other hand, if the insider discloses the information to the outsider for some reason ***other*** than intent to confer a pecuniary benefit on himself or on the outsider, then probably the outsider will not be a tippee. For instance, if the insider is merely ***indiscreet***, or is trying to right some wrongdoing (as in *Dirks v. S.E.C.*, *supra*, p. 276), the outsider typically does ***not*** become a tippee.

    Example: Remember the Executive/Bartender Example on p. 287. Executive probably won't be found to have breached a fiduciary duty to Gas Co. (even though he's guilty of serious indiscretion). Therefore, even if Bartender trades on the info, he's probably not a tippee, and won't be liable under 10b-5.

F. Disclosure between family members: Suppose that a person (let's call him X) learns information not from the issuer, but from X's ***relative***, who in turn has some connection with the issuer. Under what circumstances will X be deemed to be an insider? The

principal case on the issue has held that X is only an insider if X had a ***fiduciary responsibility*** concerning the information, and ***the mere fact that X learned the information from a relative does not with-out more give rise to a fiduciary responsibility. U.S. v. Chestman***, 947 F.2d 551 (2d Cir. 1991). *Chestman* is a case that is especially important in light of the Second Circuit's great expertise and reputation in securities-law matters.

1. **Facts:** Ira Waldbaum, president of the publicly-traded Waldbaum supermarket chain, agreed to sell the company to A&P. The sale was to take place at $50 per share, at a time when the stock was trading at about $25. Ira told his sister, Shirley, about the transaction, advising her to keep quiet about it. Shirley told her daughter, Susan, about the proposed sale; Shirley warned Susan not to tell anyone except Susan's husband, Keith Loeb, because disclosure might ruin the sale. Susan told Loeb about the sale, and then warned him not to tell anyone because it could ruin the sale. Loeb then told Chestman, Loeb's stockbroker, that Loeb had "some definite, some accurate information" that Waldbaum was about to be sold at a premium. Loeb asked Chestman what he thought Loeb should do; Chestman responded that he could not advise Loeb, and that Loeb should make up his own mind. Chestman then made several purchases of Waldbaum stock in the open market (at prices around $25); the purchases were for Chestman's own account as well as for some accounts whose investment decisions he controlled, including a purchase for the Loeb account. Later that same day, Loeb explicitly told Chestman to buy some Waldbaum shares for Loeb. Chestman was criminally charged with violating both Rule 10b-5 and the SEC's special tender-offer insider-trading rule, 14e-3 (discussed *infra*, p. 290). Here, we focus on the 10b-5 action.

2. **Holding:** By a narrow vote, the Second Circuit held that Chestman could ***not*** be convicted of a 10b-5 violation. The majority began by noting that Chestman could not be convicted of the 10b-5 violation unless there was evidence to show that: (1) Keith Loeb ***breached a fiduciary duty*** to the source of the

information (his wife or her family); *and* (2) Chestman ***knew*** that Loeb had breached such a duty. The court then concluded that Loeb had ***not breached any fiduciary duty***.

a. **Rationale:** The court reasoned that a mere familial relationship between the source of information and the tipper was not enough to impose a fiduciary duty on the tipper. Thus the mere fact that Loeb heard the information from his wife (and that she in turn had heard it from another family member) did not make Loeb a fiduciary as to the information. If Loeb and his wife had had a ***pre-existing*** fiduciary relationship (e.g., they had frequently discussed Waldbaum business matters, and Susan continued these discussions based on her understanding that her husband knew to keep them confidential), then the requisite fiduciary relationship regarding the new information would exist. Similarly, if Susan had demanded that her husband promise confidentiality ***before*** she discussed the new information with him, this would have been enough. But an after-the-fact admonition by Susan to Loeb, "Don't tell," was not enough to make Loeb a fiduciary. Therefore, Chestman was not learning information that had been transmitted in violation of a fiduciary obligation, and he could have no 10b-5 liability, any more than Ray Dirks (see *Dirks v. SEC*, *supra*, p. 276) had liability when he received information that was not the result of an insider's breach of fiduciary duty.

3. **14e-3 conviction affirmed:** But the *Chestman* court *affirmed* Chestman's conviction for violating SEC's ***Rule 14e-3(a)***, governing insider trading during the course of tender offers. This aspect of the case is discussed further *infra*, p. 290.

4. **SEC Rule:** Where non-public information is disclosed by a person to that person's close relative — the situation in *Chestman* — there is now an SEC Rule, ***Rule 10b-5-2***, on point that creates a ***rebuttable presumption*** that the recipient has a fiduciary duty to maintain the confidence. Where this presumption applies and can't be rebutted, the Rule reverses the result in *Chestman*. See *infra*, p. 293.

G. Confidential information, but not from issuer (the "misappropriation" problem): So far, we have assumed that the non-public information ***comes from the issuer*** (i.e., from the company whose stock is being traded). But suppose that material non-public information about company *A* comes from a source that has nothing to do with company *A* at all. Can a person who buys or sells shares of company *A* nonetheless be found to have violated Rule 10b-5? The answer is ***"yes,"*** at least in those situations where the trader has learned of the information by ***"misappropriating"*** it.

1. Criminal liability under other provisions: Before we look at whether 10b-5 is violated in this situation, let's first consider possible liability under ***other statutory provisions***.

a. Wire and mail fraud: Most importantly, if a person misappropriates information from another, and trades based on that information, he will be guilty of violating the general federal criminal ***mail*** and ***wire fraud*** statutes.

i. ***Chiarella:*** For instance, recall Vincent Chiarella (see *Chiarella v. U.S., supra,* p. 222), the financial printer who used information about takeover bids that he learned on his job. Although the Supreme Court found that Chiarella did not violate *10b-5* because he bore no fiduciary duty to the targets in whose stock he traded (the information came from acquirers, not targets), Chiarella could almost certainly now be convicted of mail or wire fraud — Chiarella clearly "misappropriated" information from his own employer that was given to him in confidence, and this information would be deemed to be "property" covered by the federal wire and mail fraud statute.

ii. Government official: Similarly, the wire and mail fraud statutes may cover broad ***market-related*** information that is not specifically tied to any one stock. This may often be true of secret ***government*** information. For instance, suppose that D is a member of the Federal Reserve Board, and learns at a regular monthly Fed meeting that the Fed will be raising interest rates, a move that is certain to

depress the stock market. If D sells all his stock before the public announcement of the Fed's action, D is almost certainly guilty of mail and/or wire fraud, since he has misappropriated secret government information (and has probably used a phone call or Internet communication to carry out the trade).

b. **SEC Rule 14e-3:** Furthermore, in the special case of ***tender offers***, a separate SEC rule makes it illegal to trade on the basis of non-public information, even if this information does not derive from the company whose stock is being traded (i.e., the target). Under SEC Rule 14e-3 (added after *Chiarella*), it is forbidden to trade based on tender offer information derived directly or indirectly from ***either*** the offeror or the target. Apparently, Vincent Chiarella would, today, fall right within this provision: his information about takeovers was derived indirectly from the acquirers. See Clark, p. 354.

i. ***Chestman* case:** A post-*Chiarella* case shows how SEC Rule 14e-3 can lead to an insider-trading conviction even where the trader is not guilty under Rule 10b-5. In *U.S. v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (also discussed *supra*, p. 289), D was a stockbroker who bought shares in Waldbaum Corp. based upon information from a member of the controlling family that the company was about to be taken over at a higher price. Even though D's conviction under *10b-5* was overturned on the theory that the information was not obtained in violation of a fiduciary obligation, D's conviction under *Rule 14e-3* was affirmed — 14e-3 dispenses with the requirement (imposed in 10b-5 cases) that the information have been obtained as a result of breach of a fiduciary duty.

2. **10b-5:** Now, let's consider whether ***10b-5*** is violated when a person trades based on confidential information whose source is other than the company whose stock is being traded. The answer is that the defendant ***is liable under 10b-5*** if he has ***misappropriated*** the information, by ***breaching a fiduciary relationship with the source of the information.*** This is the

result of a major Supreme Court decision, ***U.S. v. O'Hagan,*** 521 U.S. 642 (1997).

a. **Facts of *O'Hagan*:** The facts of *O'Hagan* make for a classic illustration of misappropriation from one-other-than-the-issuer, in this case from a company planning a ***tender offer*** for the issuer. Grand Met was planning a secret tender offer for Pillsbury. Grand Met hired the law firm of Dorsey & Whitney to represent it. D was a partner in Dorsey & Whitney, and learned what Grand Met was planning. (D didn't actually do any work on the matter — he just learned about it from others in the firm.) While the plan was still secret, D went out and made open-market purchases of thousands of Pillsbury shares and call options. When Grand Met announced its tender offer, Pillsbury shares skyrocketed, and D pocketed a $4.3 million profit. The U.S. government brings criminal charges against D for, among other things, violating Rule 10b-5.

b. **The defense:** D claimed that he shouldn't be liable under 10b-5, because he hadn't taken information belonging to the issuer (Pillsbury). He won with this theory in the Eighth Circuit Court of Appeals.

c. **Supreme Court rejects:** But ***D lost*** when the case got to the U.S. Supreme Court. In a 6-3 decision, the Court held that 10b-5 liability could be based upon the ***misappropriation of confidential data from a person other than the issuer.***

   i. **Statutory construction:** The case was a matter of statutory construction: what did Congress mean in §10(b) of the Exchange Act by its reference to conduct involving a "***deceptive device*** or contrivance" used ***"in connection with"*** the purchase or sale of securities? The Court found that both the "deceptive device or contrivance" requirement and the "in connection with a purchase or sale" requirement of the statute were ***satisfied*** when a person misappropriates confidential information from a non-issuer and then buys or sells the issuer's stock.

   ii. **Public-policy rationale:** The majority concluded that this

interpretation of the statute furthered the general policies behind the anti-insider-trading rules, especially the policy of ***encouraging wide participation in the securities markets:*** "Although informational disparity is inevitable in the securities markets, investors likely would ***hesitate to venture their capital*** in a market where trading based on misappropriated nonpublic information is unchecked by law.… It makes scant sense to hold a lawyer like O'Hagan a §10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder."

d. Significance: *O'Hagan* clearly broadens the population of people who can be liable for violating 10b-5:

i. Who can be covered: Anyone who "misappropriates" confidential information ***from anyone*** can be liable for trading on that information.

❏ Thus one who learns of the information as the result of a fiduciary relationship with a company ***planning a tender offer*** for X Corp. can be liable for trading in X Corp. stock. (That's what happened in *O'Hagan* itself.)

❏ Similarly, one who learns secret information about X Corp. as the result of working inside a ***publisher or broadcaster*** that's about to publish a story on X Corp. would probably also be covered.

❏ Even a person who learns the information as the result of ***securities research*** done at a ***money-management company*** would be liable, if the information "belonged" to the money-management company.

ii. Meaning of "misappropriates": It's not fully clear what situations constitute "misappropriation" of insider information. The key concept seems to be ***"deception."*** Thus the Court in *O'Hagan* said that "the misappropriation theory premises liability on a fiduciary-turned-trader's ***deception of those who entrusted him with access*** to

confidential information." Apparently if (and only if) the supplier of the information could bring some sort of ***"theft of information" tort claim*** against D, D will be liable under the misappropriation theory.

e. Recovery by acquiring corporation: *O'Hagan* was a case brought by the SEC and federal prosecutors. Suppose, instead, that a private 10b-5 action is brought by a would-be ***corporate acquirer*** against one who misuses the acquirer's information to trade in the target's stock. For instance, suppose that on the *O'Hagan* facts, Grand Met (the acquirer) sued O'Hagan, alleging that he had stolen Grand Met's information and, by his trading, caused the price of Pillsbury to go up, causing Grand Met to have to pay more to complete the tender offer.

i. Recovery may be allowed: Assuming that Grand Met can prove that: (1) D *knew* the information was the confidential property of Grand Met (highly likely); and (2) the increased price was the proximate result of D's trading (more questionable), probably Grand Met *can* recover, at least the actual profits earned by D and perhaps the entire "damages" (i.e., higher acquisition price) suffered by Grand Met.

f. SEC Rule 10b-5-2: Since *O'Hagan* establishes the misappropriation theory, application of that theory will turn on whether the recipient of the information indeed had a fiduciary responsibility — a duty of trust or confidence — not to trade on the information. (If the recipient has no duty of trust or confidence regarding the information, he will not be deemed to have "misappropriated" it to trade on it.) Yet the post-*O'Hagan* case law is very sketchy about when the relationship of trust or confidence should be deemed to exist. The SEC has tried to remove the ambiguity by setting forth, in ***Rule 10b-5-2***, adopted in 2000, a non-exclusive list of three circumstances in which ***a duty of "trust or confidence" will be found to exist*** on the part of the recipient of information:

❑ First, a duty of trust or confidence exists if the recipient

“agrees to maintain [the] information in confidence”;

- ❑ Next, a duty of trust or confidence exists if the discloser and the recipient “have a ***history, pattern, or practice of sharing confidences***, such that the recipient ***knows or reasonably should know*** that the [discloser] expects that the recipient will maintain its confidentiality.”

- ❑ Finally, under a bright-line rule, there is a *presumption* of a duty of trust or confidence if the recipient is a ***“spouse, parent, child, or sibling”*** of the discloser. However, the recipient can then ***rebut*** this presumption by showing that, in light of the relationship between the two family members, the recipient “neither knew nor reasonably should have known” that the discloser expected that the information would be kept confidential. (This right of rebuttal won’t apply if the recipient promised keep the information secret.)

g. Tippee who gets information from misappropriator: Presumably the rules of ***tip-pee*** liability will also apply to the misappropriator situation, though the Supreme Court hasn’t yet confirmed this as of this writing (April 2013). Thus if a misappropriator gives the information to a friend, with intent to make a pecuniary gift, and the friend knows or has reason to know that the information comes from a misappropriation of confidential information, presumably the friend and the misappropriator will both be liable if the friend trades on the information.

Example: On the facts of *O’Hagan*, suppose that O’Hagan (the lawyer for the acquirer) had told Fred, his best friend, “Buy stock in Pillsbury, it’s going to be taken over by one of my clients.” Fred does so. It’s highly likely that Fred will have tippee liability under 10b-5, since he had reason to know that the information was being given to him in violation of O’Hagan’s fiduciary responsibility to his client. O’Hagan would also be liable, as a misappropriator/tipper (even if O’Hagan didn’t trade himself), since he intended to give Fred

a pecuniary benefit.

H. Information about one's own trading plans: Can information about ***one's own trading plans*** ever make one an "insider" for 10b-5 purposes? The question arises most interestingly when X buys in the open market with the knowledge that he (or an entity controlled by him) will ***shortly be making a tender offer***. It could be argued that the very knowledge that one will shortly be making a public tender offer (at a price higher than the market price) is inside information of the sort that should prevent one from trading without disclosure.

1. **Not applied:** However, such trading-in-advance-of-one's-own-tender-offer is virtually ***never*** regarded as a violation of 10b-5. Indeed, those planning tender offers make it virtually standard operating procedure to amass as much stock in the open market as they can before they are required to disclose their stake. (Rule 13d-1 under the '34 Act requires anyone who acquires more than 5% of any class of stock of any public company to file a disclosure statement to that effect on Schedule 13D within 10 days of the acquisition. See *infra*, p. 438.)

2. **Rationale:** The inapplicability of 10b-5 to this situation makes sense, since the information about one's own future plans does not derive from the issuer itself — one therefore does not have any fiduciary responsibility to the company or its shareholders concerning that information (thus taking the case outside of 10b-5 under *Chiarella*'s requirement that a fiduciary responsibility to the issuer be breached for there to be a 10b-5 violation).

Quiz Yourself on ***INSIDER TRADING*** *(SEC RULE 10b-5)*

58. Aquaman is president of a marine research company, Wet Dreams, Inc. On April 1, the research director of Wet Dreams tells Aquaman they've come up with "Oxygum," a means of breathing underwater by chewing a special kind of gum. Aquaman knows a great product when he hears it. He delays announcing the invention to the public, so he can buy up all the

Wet Dreams stock he can get his hands on. Sure enough, when Aquaman makes the announcement, the price of Wet Dreams stock immediately rises from $1 to $50 a share.

(a) What SEC rule, if any, is Aquaman likely to have violated?

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(b) Has Aquaman in fact violated that rule?

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59. Choo Choo Charlie is president of Good, Inc., a manufacturer of black licorice candy, whose common stock is traded on the NYSE. He negotiates an acquisition of Plenty, Inc., a company that makes hard candy coatings. After the acquisition, the company will be known as Good & Plenty, Inc. Once the main terms of the acquisition are finalized, Choo Choo Charlie waits a week before announcing it in a press release, so that Plenty can notify one of its vacationing directors. During that week, a Good shareholder, Olive Oyl, sells 1,000 shares of her Good stock at the market price, $10 a share. When Choo Choo Charlie finally announces the acquisition, Good stock rockets to $15 a share. Olive brings a private action against Charlie for violating SEC Rule 10b-5. Will Olive recover? ______________________________

60. Richard Squishy, CEO of HealthNorth Corp., has just learned from his CFO that the company has earned lower-than-expected profits for the just-completed quarter. He sells 100,000 shares of stock for gross proceeds of $2 million before the lower profits are announced to the public. When sued by the SEC for insider trading, he argues, “I concede that I knew about the lower earnings. However, I made the sale not for that reason, but because I needed the $2 million for a new house that I was contractually obligated to pay $3 million for the next week.” Assuming that the trier of fact believes that Squishy is telling the truth about his motivation, is he liable for insider trading?

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61. Santa Claus is president of publicly traded Hohoho, Inc., a company that makes wooden toys and delivers them to children all over the world on Christmas Eve, charging parents. Hohoho’s marketing VP, Rudolph Reindeer, convinces Santa that there are big “bucks” to be made in buying toys from other manufacturers and passing them on to parents at a

higher price. On July 1, Santa negotiates a huge contract with Skin-tendo Computer Games. Santa then waits until July 15 before he announces the contract in a press release. During the period from July 2 through July 14, Santa buys 10,000 shares of Hohoho at $10. After the announcement, the shares quickly rise in price to $15. Then, over the next 2 months, they rise to $25. Cindy Lou Hoo, who dabbles in stock as a hobby, files a private 10b-5 claim against Santa. Cindy Loo alleges that: (1) she already owned 2,000 shares of Hohoho as of July 1; and (2) she would have bought an additional 1,000 shares of Hohoho stock on July 3, had Santa disclosed the Skintendo contract promptly. She therefore claims that Santa's failing to promptly disclose the contract, while trading in the stock, has cost Cindy Lou profits she would have made. Assuming that the court believes Cindy Lou's factual assertions, will Cindy Lou recover (and if so, how much)? ___________________________

62. The Nat King Coal Mining Company is always drilling at new test sites. One such site, on Nomansan Island, is quite positive. Nat King's chief geologist tells company insiders that in his judgment, there's a 30% chance that the Nomansan site has commercial quantities of coal; he also tells them that if the site is in fact commercially viable at all, it's probably a huge find, which will at least double the company's proven reserves. Immediately (and before anything is said to the public), the corporation's vice president of operations, Cole Dust, buys up all the Nat King Coal stock he can afford. Sure enough, the find turns out to be commercially viable, the stock price skyrockets, and Cole's a rich man. The SEC sues him for insider-trading in violation of 10b-5.

(a) If you represent Cole, what defense would you offer?

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(b) Will the defense you raise in (a) succeed?

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63. James Bond is sitting at a bar drinking a vodka martini, shaken not stirred. He overhears a man nearby telling a friend about how his company has secretly been buying up gold bullion on the world market, to such an extent that it now controls the market. Bond looks up and recognizes the man as Auric Goldfinger, chairman of the publicly traded Twenty-Four Carat Corp. Bond checks out the financial papers and finds

out that this information hasn't been made public. He buys up all the Twenty-Four Carat Corporation stock he can, and, sure enough, when the information becomes public, the stock price skyrockets. Has Bond insider-traded in violation of Rule 10b-5? ____________________________

64. D.B. Cooper is president of Cooper Printing, Inc., a publicly traded company. He goes out for drinks one night at the Parachute Inn. He meets a woman, Brenda Starr, and they share a few cocktails. D.B. doesn't hold his alcohol too well, and he blabs to Starr that the reason Cooper Printing is doing so well is that, when the presses aren't busy, they print counterfeit money. He adds that the FBI is hot on their tracks, and will probably discover the counterfeiting operation soon. It never occurs to D.B. that he's conveying commercially-valuable information. However, Brenda drinks in this hot tip and, the next day, sells short as much Cooper Printing stock as she can. (That is, she sells borrowed shares, hoping the price will fall and she can buy them back at a lower price, pocketing the difference.) The SEC discovers all of the above facts, and charges Brenda with insider trading in violation of Rule 10b-5. Is Brenda liable?

65. "King" Lear is director of research at the Bard of Avon Company, which produces men's cosmetics. A researcher at Bard of Avon, Dorian Gray, comes up with a treatment that stops aging. Lear knows a gold mine when he sees one, and, before the breakthrough is announced, he buys all the Bard of Avon shares he can afford — 10,000 shares at $5 a share — on the NYSE. That same day, Lady Macbeth sells 50,000 Bard of Avon shares at $5 a share. The following day, Gray's treatment is announced by Bard of Avon's president, Shakespeare, and the stock price shoots up to $10 a share. Lady Macbeth brings a claim against Lear for insider trading, under the federal statute giving an express private right of action in these circumstances. Assuming that Lady M. proves all elements of her claim, how much will she recover? ____________________________

66. Jim Kirk is president of Tribble Trouble Inc. ("TTI"), a closely-held corporation with 5 shareholders. TTI owns a tribble ranch, on which it raises fuzzy little tribbles that are sold as exotic housepets. Kirk phones Mr. Spock, a neighbor who is also a TTI shareholder, and tells him the ranch is having breeding troubles, and the outlook isn't very good. Kirk encourages Spock to sell Kirk Spock's shares for $50 each. At a face-to-

face meeting the next day, Spock sells Kirk the shares at the $50/share price. In reality, the tribbles are reproducing like rabbits, and Spock's shares would really have been valued at $200 each by an investor who knew the full facts. When Spock finds out about Kirk's lie, he gives Kirk a Vulcan neck pinch at the next block party, and then files a 10b-5 claim against him in federal court. Kirk challenges the claim on the grounds that: (1) Rule 10b-5 does not apply to transactions in the stock of non-publicly-traded companies; and (2) 10b-5 does not apply where no instrument of interstate commerce is used in connection with the transaction. Which, if either, of these defenses will be successful?

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67. Same facts as the previous question. Now, however, assume that Kirk, instead of phoning Spock, rang Spock's doorbell, told Spock face-to-face how business was bad, and bought Spock's shares in that same meeting. What, if any, defense could Kirk raise to a 10b-5 suit, that Kirk could not have raised in the prior question? ______________________________

Answers

58. **(a) SEC Rule 10b-5.** That rule (roughly) makes it unlawful to "employ any device, scheme, or artifice to defraud … in connection with the purchase or sale of any security." [262]

(b) Yes. A person commits insider trading in violation of Rule 10b-5 if he (1) has a special relationship with the issuer of stock (e.g., he is an "insider" of the issuer), and (2) buys or sells the issuer's stock, while in possession of information that is (3) material and (4) non-public. [263] Aquaman, as president, was an insider of the corporation whose shares were being bought (Wet Dreams), so Aquaman satisfies (1) and (2). Information is "material" if a reasonable investor would consider it important in deciding whether to buy or sell the shares. [272] Information that in fact increases a company's share price from $1 to $50 is clearly "material" (satisfying (3)). The Oxygum invention hadn't been known to investors generally when Aquaman made his purchases, so the information about the invention was "nonpublic" (satisfying (4)). As a result, Aquaman is liable for insider trading in violation of Rule 10b-5.

59. **No, because Charlie didn't trade in Good shares before the acquisition was made public.** The rule on insider trading is that insiders may not *trade* in the company's stock while in possession of material inside information. 10b-5 does not require the prompt disclosure of material non-public information: the company and its insiders may delay disclosure indefinitely so far as the Rule is concerned, so long as they don't buy or sell in the interim. This is the "disclose or abstain" rule. [264] Here, Charlie abstained. Thus, he can't be liable to Olive.

60. **Yes**. An SEC Rule enacted in 2000, Rule 10b-5-1, forecloses Squishy's defense. The Rule starts by saying that Rule 10b-5 prohibits trading "on the basis of" material nonpublic information. But 10b-5-1 then defines "on the basis of" to *mean* ***"was aware of"*** the information at the time of the purchase or sale. Since Squishy was "aware of" the info when he sold, he's liable, even if the "motivation" for his sale was his need for house-acquisition funds rather than the inside info. (10b-5-1 would have given Squishy a "safe harbor" if, before he got the lower-earnings news, he had irrevocably committed to sell the shares as part of a pre-planned trading program, such as a commitment to sell a certain number of shares at the beginning of every quarter regardless of market conditions. But there's no indication on our facts that Squishy qualified for this safe harbor.) [271-272]

61. **No — Cindy Lou Hoo loses, because only purchasers or sellers of the affected securities can be plaintiffs under 10b-5.** More precisely, a person can only be a plaintiff if she bought or sold the company's stock *during the period of non-disclosure*. *Blue Chip Stamps v. Manor Drug Stores.* [269] Since Cindy didn't buy or sell any Hohoho stock during the period when the insider-trading was occurring — July 2 through July 14 — she can't recover, no matter how clear it is that Santa in fact violated 10b-5 (and it's very clear here that he did).

62. **(a) That the non-public information was not "material."** Insider trading violates Rule 10b-5 only if the defendant bought or sold while in possession of "material" non-public information. Cole can make a plausible argument that because there was only a 30% chance that the site would be commercially viable, the news about it wasn't material.

    (b) No, probably. Information is "material" if there is a "substantial

likelihood” that disclosure of that information “would have been viewed by a reasonable investor as having significantly altered the ***‘total mix’*** of information made available.” [272] A 30% chance that a coal company’s proven reserves will at least double would almost certainly be viewed as significantly altering the “total mix” of information about the company’s prospects.

63. No, because Bond had no disclose-or-abstain duty. Bond did trade on the basis of material, nonpublic information. However, that by itself doesn’t violate 10b-5. Instead, the only people subject to liability are pure insiders (directors, officers, controlling shareholders, employees), temporary insiders (accountants, lawyers, investment bankers, etc.), misappropriators, and tippees (those to whom an insider knowingly discloses inside information in breach of a fiduciary duty). [273] Bond fits none of these descriptions. Instead, what he did was, essentially, to obtain market information by chance. It’s perfectly OK to trade on the basis of such information.

If Goldfinger had *known* that Bond was listening, and had intended to give Bond the information so that Bond could make money by trading the company’s stock, then Goldfinger would be a tipper and Bond would probably be liable as a tippee. [288] But since Goldfinger didn’t even know that Bond was listening, Goldfinger is not a tipper and Bond is not a tippee.

64. Probably not. Here, Brenda is not herself an insider in Cooper Printing, so if she’s liable at all it would be as a tippee. A tippee’s duty to disclose or abstain derives from the liability of his tipper (here, D.B.) [276] A tipper is only liable for the disclosure if the tipper is breaching his fiduciary duty to the issuer’s shareholders by making the disclosure. Furthermore (and this is the not-so-obvious step), the tipper will be deemed to be breaching his fiduciary duty only if he “personally will benefit, directly or indirectly, from his disclosure.” *Dirks v. SEC.* [276] If D.B. had expected Brenda to make money from trading on the tip and give him a portion — or even if D.B. had just intended to make a pecuniary gift to Brenda by giving her information on which he expected her to trade — D.B. would be in breach of his fiduciary duty, and Brenda would be derivatively liable if she realized that D.B. was violating his duty. But here — where the facts tells us that D.B. has no idea that

Brenda will use the info for personal gain — D.B. hasn't violated any fiduciary duty, so Brenda can't be derivatively liable no matter how bald-faced her conduct may have been.

65. **$50,000 — 10,000 shares x $5 profit per share.** Congress has given certain types of claimants an express private right of action for insider trading, under the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). Under that Act, damages "shall not exceed the profit gained or loss avoided in the … transactions … that are the subject of the violation." [285] Therefore, Lady M. is limited to the *lesser* of her own lost profits (50,000 x $5, or $250,000) and the defendant's gains ($10,000 x $5, or $50,000).

    RELATED ISSUE: Say the plaintiff had been the *SEC*, not a private plaintiff like Lady Macbeth. The SEC could seek, among other remedies, *treble damages* under ITSFEA — the SEC is not limited to recovering the defendant's actual gains made or losses avoided. [286] (These damages would go to the Treasury.)

66. **Neither.** As to (1), this is simply a misstatement — 10b-5 applies to transactions involving any "security," whether publicly-traded or not. [265] So the fact that TTI is privately-held is irrelevant. As to (2), the statement of law is (roughly) correct, but it doesn't apply to these facts. That's because Kirk used the telephone as part of his scheme, and the telephone is considered to be an instrument of interstate commerce.

67. **Lack of jurisdiction.** The statutory section that supplies authority for Rule 10b-5 requires that D's fraud have been "by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange." [268] Since on these facts neither phone nor mail (nor any other instrument of interstate commerce) was used, and the stock was not traded on a stock exchange, the transaction was a purely intrastate one and there is nothing to satisfy the quoted jurisdictional requirements.

V. RULE 10b-5 — MISREPRESENTATIONS OR OMISSIONS NOT INVOLVING INSIDER TRADING

A. **Beyond insider trading:** We now focus on those acts that may violate 10b-5 even though they do ***not*** involve conventional ***"silent"*** insider trading. Recall that 10b-5 prohibits any "fraud or deceit" in connection with the purchase or sale of any security. Certain ***misrepresentations***, and perhaps even omissions, may constitute violations of 10b-5 even though the case does not fall within the conventional pattern of a person who buys or sells based on non-public information about the company whose shares are being traded.

B. **Breach of fiduciary duty as a kind of fraud:** Recall that Rule 10b-5 forbids any "fraud or deceit upon any person, in connection with the purchase or sale of any security." Suppose a director, officer or controlling shareholder violates his ***state-law fiduciary duties*** in connection with buying or selling stock in the company. Can this violation of fiduciary duties constitute a "fraud" covered by 10b-5, even if there is no lie? If the answer is "yes," a shareholder would often prefer to bring a federal 10b-5 damage action instead of a state-law action, for various procedural reasons (e.g., better choice of venue, nationwide service of process, etc.). However, as we shall see, in the absence of an actual misrepresentation or half-truth, breach of state-law fiduciary duties does ***not*** give rise to a 10b-5 claim.

   1. **Lie to directors:** First, let us consider a comparatively easy case: an insider (director, officer or controlling shareholder) ***lies to the board of directors*** or the compensation committee and induces them to ***sell him stock*** on favorable terms. Here, there is clearly a 10b5 violation, even though the trade takes place directly with the corporation.

      Example: D, the chief scientist of XYZ Corp., is aware that his employees have just made a major discovery that is likely to be translated into significantly higher earnings for XYZ. At a time when the board of directors of XYZ is not yet aware of the discovery, the board asks D whether there have been any major developments in his department, and he falsely says "no." The board then issues D stock, or a stock option, perhaps as part of a general plan of incentive awards for top

executives. If D accepts the stock or options, he has violated 10b-5, because his false denial of significant developments is a "fraud … in connection with the purchase or sale of [securities]." (The same would be true if the board did not ask D about the development, he failed to disclose it, and he accepted the option they awarded him. This was one of the express holdings of the court in *SEC v. Texas Gulf Sulphur*, *supra*, p. 265.)

2. Breach of duty without misrepresentation: Now, consider the more difficult case in which D ***violates his fiduciary duties*** to the corporation of which he is an insider, but this violation does not involve any misrepresentation or, for that matter, any non-disclosure of something that D is obligated to disclose. Can the breach of fiduciary duty by itself be a violation of 10b-5, on the theory that it is a kind of fraud, perhaps "constructive fraud"? The answer is ***"no,"*** as the result of ***Santa Fe Industries, Inc. v. Green***, 430 U.S. 462 (1977).

a. Facts: In *Santa Fe*, D (Santa Fe Industries, a corporation) owned 95% of the stock of Kirby Lumber Corp. Under applicable Delaware "short-form" merger provisions, a parent corporation that owns more than 90% of the stock of a subsidiary corporation may "cash out" the minority by buying their shares whether the minority consents or not. (A minority holder may then petition the court for an appraisal to determine the fair price for the stock, if he does not agree with what the majority holder is offering. See *infra*, p. 394.) D complied with all the terms of this short form statute, and thereby put through a merger under which the minority holders in Kirby were offered $150 per share. The Ps were minority holders in Kirby who were unhappy with the $150 per share price, but did not want to use their state-law appraisal rights. Instead, they brought a federal suit under 10b-5, claiming that when D put through the merger at what was (the Ps asserted) an unfairly low price, D was engaging in a kind of "fraud or deceit" upon the minority.

b. Holding: But the Supreme Court ***rejected the Ps' argument,***

and held that they did ***not*** state any 10b-5 claim. As long as there was no "omission" or "misstatement" in the information given by D to the Ps, there was no "fraud" and thus no 10b-5 violation. 10b-5 simply does not, the Court held, cover situations in which "the essence of the complaint is that shareholders were ***treated unfairly by a fiduciary***."

c. **Rationale:** Perhaps the main reason why the Court found 10b-5 inapplicable to this "substantive unfairness" situation was that the Court did not want to ***federalize the law of fiduciaries***. Traditionally, the rules governing fiduciaries, especially corporate insiders, have been the subject of state, not federal, regulation. If a 10b-5 action could be brought any time an insider violated a state fiduciary rule, the federal courts would end up interpreting and applying state law, with which they have no expertise.

d. **Fiduciary breach includes deception:** But it is important to keep in mind that *Santa Fe* only bars a 10b-5 action where there is ***no deception*** by the insider. If, as part of the insider's violation of his fiduciary obligations to the corporation and its shareholders, he ***deceives*** the corporation, its board or the minority shareholders, then a 10b-5 action will still be available despite *Santa Fe*. This exception is especially likely to be invoked where a ***majority*** or ***controlling stockholder*** causes the corporation to sell stock to him or buy stock from him, and the controlling stockholder ***does not make full disclosure*** to the company or its other shareholders.

i. **Disclosure to disinterested board:** More specifically, the minority shareholders of a corporation may have a 10b-5 claim against the majority that sells stock to, or buys stock from, the corporation, if the transaction falls into ***either*** of two factual settings:

(1) **Shareholder approval required:** If ***shareholder approval*** was ***required under state law*** for the particular transaction, the Ps probably have a 10b-5 claim if they can show that they were not given ***full disclosure*** of the

transaction. (We assume, of course, that the transaction involves a purchase or sale of stock in the corporation of which the Ps are stockholders.) In this situation, the fact that full disclosure was made to the board of directors is irrelevant.

(2) Shareholder approval not needed: If, under state law, shareholder approval was ***not*** required, the Ps may still be able to win if they can show that: (1) the disinterested ***directors*** were not given full disclosure; ***and*** (2) had full disclosure been made, the disinterested directors might well have rejected the transaction, or the court might well have blocked it as unfair. See S,S,B&W, p. 867.

C. Misrepresentation without trading: Suppose the corporation itself or one of its executives makes a ***false statement*** but ***does not trade*** in the company's stock. Can the corporation or the officer still be liable for a 10b-5 violation? The answer is "yes" — only the plaintiff, not the defendant, needs to have bought or sold the corporation's stock.

1. Scienter required: Remember, however, that the plaintiff in a 10b-5 action must always show ***scienter***, i.e., intent to deceive, on the part of the defendants. Thus if the defendant makes a false statement, but was ***honestly (even if unreasonably) mistaken***, there will be no 10b-5 liability. (On the other hand, if D speaks with ***reckless disregard*** of whether the statement is true or false, this recklessness ***will*** constitute scienter; see *supra*, p. 277.)

2. Merger discussions: The problem of false statements by non-traders occurs most frequently in the case of a company that is undergoing secret ***merger negotiations***. The target company will often have a strong interest in not acknowledging publicly that merger discussions are under way. First, the suitor may insist on this, because it does not want to be drawn into a bidding war, and will negotiate secretly or not at all. Secondly, the target may feel, perhaps quite reasonably, that the discussions are very preliminary and speculative, and that disclosure would attribute

more importance to the discussions than they in fact warrant. Finally, the target may worry that public acknowledgment of the discussions will put the company "in play," i.e., subject it to a public bidding contest where management has little choice but to sell to the highest bidder.

- **a. Issue:** Therefore, the issue becomes: If rumors start to fly about a possible merger, can the target company ***falsely deny*** that discussions are underway? In brief, the answer is "no": if the company knows that it is having even preliminary merger negotiations, it cannot flatly make statements such as "There are no merger negotiations underway" or "We know of no reason why the price and trading volume of the stock are rising." But there are at least two ways in which the company may be able to avoid liability without confirming secret discussions:

- **b. Materiality:** First, one only has 10b-5 liability for ***material*** misrepresentations. If merger discussions are so ***preliminary*** and ***speculative*** that a reasonable investor would not consider them important in deciding whether to buy, sell or hold the stock, the discussions are not "material," and a false denial that they are occurring is not a misstatement of a material fact. See *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), *supra*, p. 272.

- **c. Statement of no comment:** Perhaps more importantly, the company can almost always avoid 10b-5 liability by saying ***"no comment"*** when it is asked about the discussions. As the court said in *Basic, Inc.* (fn. 17) "***Silence***, absent a duty to disclose, is ***not misleading*** under Rule 10b-5. 'No comment' statements are generally the functional equivalent of silence." A company's right to remain silent about corporate developments is discussed further *infra*, pp. 302-302.

  - **i. Difficulty:** Of course, if the company always explicitly and truthfully denies merger discussions when none are pending, and then suddenly switches to a "no comment" response when discussions really are pending, the "no

comment" response will be seen as silent confirmation of the truth of the merger rumors, the very fact that the company presumably wants to keep secret. Therefore, the wisest thing for the company to do is to adopt ***in advance*** a "no comment" policy concerning ***any*** merger discussions, true or false.

ii. **Insider trading problem:** Also, if material merger discussions are under way and the company uses the "no comment" policy, the company and insiders aware of the discussions may not ***buy or sell*** the company's stock. A purchase or sale by them would fall squarely within 10b-5's ban on insider trading.

iii. **Exchange policies:** Finally, even if no insider trades on the stock, use of the "no comment" policy when important discussions were in fact underway would probably violate the requirements of any ***stock exchange*** on which the stock was traded. See, e.g., New York Stock Exchange Company Manual §§202.03 and 202.05.

3. **Reliance:** Where P claims that D has made an affirmative misrepresentation, must P nonetheless show that he directly ***knew*** of and ***relied*** upon the misstatement? The answer is ***"no"*** — P gets the benefit of "fraud on the market" theory, whereby he will be ***presumed*** to have relied upon the misstatement in the sense that the misstatement affected the market price at which P's purchase or sale took place. Indeed, *Basic, Inc. v. Levinson*, the case in which the "fraud on the market" theory was finally accepted by the Supreme Court, was a case in which the defendant company falsely denied that it was engaged in merger negotiations. See *supra*, p. 272.

4. **Fraud by one not associated with issuer:** Even a person ***not associated with the issuer*** can commit fraud (and thus violate 10b-5) by knowingly or recklessly making a false statement about the issuer or the issuer's stock.

   Example: Broker tells Client that XYZ Corp. has just made a major new invention, and that XYZ's stock price will

probably soar as a result. Broker has no connection with XYZ, and Broker knows that his information is false. Client buys XYZ stock, as Broker hopes he will do. By making a false statement in connection with the purchase or sale of a security, Broker has violated 10b-5; this is so even though Broker has no connection with the issuer (XYZ).

D. Statements made while one's own stock position concealed: Concealment of ***one's own stock holdings*** may constitute the sort of "misrepresentation or omission" that can give rise to 10b-5 liability, even in the absence of conventional insider trading.

Example: D is a financial columnist for MoneyWeek Magazine. D buys lots of stock in XYZ Corp., then publishes a column in which he accurately summarizes XYZ's favorable characteristics and urges his readers to buy the stock. (He intends to influence the market price so that he can sell out at a profit if the stock rises.) The stock rises, and D sells out at a profit. D's column fails to mention D's own substantial position. Even though D's column is accurate (in the sense it does not contain any affirmative misrepresentations), D has probably violated 10b-5 because he has deceived his readers by making a misleading omission (that is, he has failed to disclose that he has a strong ulterior motive for his recommendation). Also, this conduct might be a "manipulation" of XYZ stock, similarly forbidden by 10b-5. See Clark, p. 348.

E. Omission by non-trader: Suppose that the company or an insider simply ***remains silent***, i.e., ***fails to disclose*** material inside information that it possesses. So long as the company or insider is not affirmatively ***misleading***, and so long as it or he does not buy or sell the company stock during the period of non-disclosure, there is ***no violation*** of 10b-5. This is true even if market rumors (correct ones as it turns out) are flying fast and furious, and the company's stock price and trading volume are being heavily affected.

1. Exceptions: But there are two ***exceptions*** to this general rule

that the company cannot be liable under 10b-5 for a mere failure to disclose:

a. **Leaks by company or its agents:** First, if rumors are the result of ***leaks*** by the company or its agents, the company probably has an obligation to confirm correct rumors or correct false ones.

b. **Involvement in outsider's statements:** Second, the company may so ***involve*** itself with outsiders' statements about the company that the company will be deemed to have assumed a duty to correct material errors in those outsiders' statements.

Example: X, a securities analyst, submits his estimates of ABC Corp.'s next quarterly earnings to ABC's investor relations director, W. W knows that these estimates are much too optimistic, but says nothing. X releases them to the public, the public is misled into bidding up the price of ABC stock, and the stock plunges when the real earnings are eventually released. ABC and/or W might well be held liable for violating 10b-5, on the theory that W's silence in the face of X's estimate was an implied representation that the estimate was reasonable.

F. **Private class actions:** An important aspect of 10b-5 liability not involving insider trading is the potential for ***private class-actions.***[7] Investors who have lost money based upon misleading statements by corporate insiders can sue en masse for those losses. Such actions can create potential liability in the billions of dollars.

Example: Suppose that XYZ Corp. is a large corporation with a $50 billion market capitalization. Rumors have started to float that XYZ's earnings will be down; the stock price has dropped from $50 to $35. On June 1, Prez, the company's chief executive, issues a statement saying, "Our business is as strong as ever — earnings are expected to be $1 per share for the quarter that will end June 30, compared with $.75 for the same quarter last year, and for the whole current year they are expected to be $4.25 compared with last year's $3.20." At the

time Prez makes this statement, he knows that it's very unlikely that XYZ will in fact achieve anywhere near the earnings he's just promised. The stock rallies back to $45 on Prez' announcement. 8 weeks later, on August 1, the actual quarterly results are announced: the company loses $1.50 instead of making $1 (a loss that Prez in fact foresaw at the time he made the earlier pre-announcement). The stock plummets to $20.

A federal-court 10b-5 class action could be brought against Prez on behalf of all investors who bought XYZ stock between June 1 and August 1, for the difference between the price paid by each holder and $20 (the price after the misrepresentation was corrected). Since Prez made an intentional misrepresentation about a material fact and the class members presumptively acted in reliance on that misrepresentation, recovery ought to be allowed. If a large portion of the XYZ's outstanding stock changed hands during this period, the damages could easily amount to billions of dollars.

1. **Abuses:** In the early 1990s, there was increasing evidence that plaintiffs' class action lawyers were abusing the system by bringing frivolous 10b-5 ***"strike suits,"*** especially against high-growth technology companies. That is, lawyers were bringing suits "not because plaintiffs or their class action lawyers had any persuasive evidence of fraudulent conduct on the part of the defendants but primarily as an *in terrorem* device for ***extracting settlements*** from the defendants irrespective of the merits. … [U]nwarranted settlements could be extracted because plaintiffs and their counsel, at relatively little cost and risk to themselves, were able to impose enormous ***discovery costs*** and the risks of ***astronomical damage awards*** on defendants." 51 Bus. Law 1009 (1996) (quoted in Hamilton (7th)).

2. **Reform Act to curb abuses:** Congress tried to curb these abuses by passing the Private Securities Litigation Reform Act of 1995 (the ***"Reform Act"***). A few of the key provisions of the Reform Act (all applicable only to *federal* securities-fraud class

actions) are:

- ❑ **Incentives for lawyers:** The ***incentives*** for ***class-action lawyers*** who represent just a few small shareholders are ***reduced***. For instance, the lead attorney's fees are capped at a ***"reasonable percentage"*** of the amount of damages paid to the class, and there is a presumption that the plaintiff with the largest financial interest should be the lead plaintiff, who then gets to select lead counsel.

- ❑ **Discovery delayed:** ***Discovery*** (together with the large costs associated with it, especially on the defense side) is ***delayed*** until after the defense has had a chance to bring a motion to dismiss. This prevents plaintiffs from using discovery as a ***"fishing expedition."***

- ❑ **Proportionate liability in some cases:** In many situations, defendants will ***not be jointly and severally liable*** — instead, there is ***"fair share" proportionate liabilty***, thereby decreasing the risk that any individual defendant will be ruined by a large, unexpected judgment. (Congress believed that the small but non-zero risk of total ruination contributed to settlements that were unreasonably large relative to the likely outcome on the merits.)

- ❑ **Pleading of state of mind:** Perhaps most important, where (as is usually the case) the result is dependent on the defendant's having acted with a particular state of mind, the complaint must "state with ***particularity facts*** giving rise to a ***strong inference*** that the defendant acted with the required state of mind." '34 Act, §21D(b)(2).

See generally Hamilton (8th), pp. 1117-1122.

3. Reform Act not wholly successful: The Reform Act seems not to have been very successful. The number of federal securities-fraud class actions has actually gone up, not down, since the Act was passed, and the average settlement amount has increase fourfold. Hamilton (8th), p. 1122.

a. State-court suits: Furthermore, the Reform Act seemed to

spawn a dramatic increase in the number of securities fraud class actions filed in the ***state courts*** — plaintiffs' lawyers seem to have decided that if federal class action suits are now more difficult to bring and win, they should simply select a different forum, and a different body of law.

b. SLUSA: Congress responded once again, by passing the Securities Litigation Uniform Standards Act of 1998 (***"SLUSA"***). SLUSA "***preempts*** most securities fraud class actions brought in ***state court.***" (Hamilton (7th), p. 1040.)

i. Traditional state-law actions preserved: However, SLUSA does ***not*** preclude suits that are based on traditional areas of ***state corporate law.*** This exception is known as the ***"Delaware carve-out."*** For instance, under the carve-out SLUSA doesn't preclude traditional ***derivative suits*** (see *infra*, p. 318), where the claim is brought on behalf of the entire corporation. Nor does it preclude state class-action suits based on insiders' breach of state-law fiduciary duties regarding certain transactions between the corporation and its stockholders.

ii. Effect of SLUSA: Despite the Delaware carve-out, SLUSA seems to be having some real impact. In the garden-variety scenario in which the claim is that some ordinary-course communication by the corporation or its insiders was fraudulent, any class-action will have to be in federal court. Thus in our example on p. 302 (fraudulent statement about what the level of earnings would be), any class action would have to be brought in federal court.

Quiz Yourself on ***INSIDER TRADING (AND RELATED TOPICS)*** *(RULE 10b-5 — MISREPRESENTATIONS OR OMISSIONS NOT INVOLVING INSIDER TRADING)*

68. McSpeedy Gonzales is a corporation that runs a chain of very fast food restaurants. Mary McCheese, a stockbroker for the firm of Merrily

Lynchem, tells Sylvester Katt in a phone conversation that McSpeedy Gonzales has just reported profits of $2 a share for the most recent quarter, and that in McCheese's opinion the stock is an excellent buy. McCheese knows that in fact the company has made only a $1 per share profit (down from the prior year), and that the $2 figure is due to a computational error by Merrily's fast-food analyst. Sylvester relies on his conversation with McCheese, and buys 1,000 shares of McSpeedy. The truth about McSpeedy's earnings comes out a week later, and the stock tanks. Sylvester sues McCheese for a 10b-5 violation. McCheese defends on two grounds: (1) that she neither bought nor sold McSpeedy stock at any time; and (2) that she was not a McSpeedy corporate insider, nor did she learn her information by means of a breach by anyone of a fiduciary duty to McSpeedy. Therefore, she says, she can't have violated 10b-5. If McCheese's two factual assertions are correct, which, if either, of McCheese's defenses is valid? ___________________________

Answers

68. Neither. Rule 10b-5 prohibits (among other things) misstatements and omissions of material fact "in connection with the purchase or sale of any security." When D knowingly makes an affirmative misstatement of material fact to P about a security, and this induces P to buy or sell that security, P can recover from D for a 10b-5 violation even though D never bought or sold the company's securities, and even though D was not a company insider and didn't learn any nonpublic fact by means of a breach of fiduciary duty on the part of a company insider. [301]

If you got this question wrong, it's probably because you confused suit based on affirmative misrepresentation (which is what we have here) with a suit based on *insider trading*. If P's claim is that D has insider traded, then P must show both: (1) that D bought or sold the issuer's stock while in possession of material nonpublic information; and (2) that D was either an insider of the issuer or learned the information by means of a breach by someone of a fiduciary duty. But neither of these requirements applies to suits based on affirmative misrepresentation. So here, since McCheese knew that she was making an incorrect statement about McSpeedy's earnings, she's violated 10b-5 and Sylvester can recover. Thus in the

garden-variety "fraud by a broker" scenario, the broker has typically violated 10b-5.

VI. SHORT-SWING TRADING PROFITS AND §16(b)

A. Introduction: Entirely apart from Rule 10b-5, the federal securities laws contain another major statutory provision that was originally designed to combat insider trading. This is §16(b) of the Securities Exchange Act of 1934, whose principal provisions read as follows:

> "For the purpose of preventing the unfair use of information which may have been obtained by [any beneficial owner of ***more than 10%*** of a ***class of stock***], ***director***, or ***officer*** by reason of his relationship to the issuer, ***any profit*** realized by him from ***any purchase and sale***, or any sale and purchase, of ***any equity security*** of such issuer … within ***any period of less than six months*** … shall inure to and ***be recoverable by the issuer***, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. … This subsection shall not be construed to cover any transaction where such beneficial owner was not such ***both*** at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt.…"

1. **Summary:** So to summarize how §16(b) operates: if an ***insider*** (director, officer or 10%-stockholder) ***buys-and-then-sells*** (or sells-and-then-buys) with ***less than six months elapsing*** between the purchase and the sale (or the sale and then purchase), the insider is automatically required to ***pay back to the corporation all profits*** from the transaction.

2. **Purpose:** In enacting §16(b), Congress reasoned that a "bright line" rule would be an effective way to stamp out at least some types of insider trading. Therefore, the rule applies ***automatically***: if one of the statutorily-defined insiders buys stock in his company on, say, Feb. 1 and sells it at a profit on June 1 (or sells on Feb. 1 and repurchases it for less on June 1), he is ***automatically*** required to return the profits to the corporation, ***even if he had absolutely no insider knowledge***.

B. Overview: Here are some of the highlights of §16(b)'s operation:

1. **Who is covered:** Section 16(b) defines quite specifically the insiders who are covered by it: ***officers***, ***directors***, and anyone who is directly or indirectly the ***beneficial owner*** of ***more than 10%*** of any class of the company's stock. Thus someone who might be an actual or constructive insider for 10b-5 purposes will not necessarily be an insider for 16(b) purposes — for instance, an outside professional (e.g., lawyer or investment banker) who is given information about the company, or a low-level employee who happens to learn important non-public information while on the job, is not covered by 16(b)'s short-swing profits rule unless he happens to be an officer, director, or more-than-10% owner.

2. **Only public companies:** Only officers, directors, and 10% shareholders of companies which have a class of stock ***registered*** with the SEC under §12 of the '34 Act are covered. That is, the insider will be covered only if the company either: (1) is listed on a national securities exchange; or (2) has assets greater than $10 million and a class of stock held of record by 500 or more people. See §12(g) of the '34 Act, and SEC Rule 12g-1. So as a practical matter, all "publicly held" companies are covered, but privately held companies are not. (Recall, by contrast, that SEC Rule 10b-5 applies even to the securities of "privately held" companies. See *supra*, p. 265.)

3. **Who may sue:** Suit may be brought by the corporation or by ***any shareholder*** (even one who did not own any shares when the insider's transactions took place). However, even if the suit is brought by the shareholder, any recovery goes into the ***corporate treasury***, not to the successful plaintiff-shareholder.

   a. **Attorneys' fees:** Why then would any shareholder ever bring a 16(b) action? Because the court will award ***attorneys' fees*** to the plaintiff's lawyer if the action is successful. Therefore, as a practical matter 16(b) actions are almost always engineered by the lawyer, and the plaintiff is typically someone with almost no financial stake in the corporation (e.g., a person who is persuaded to buy one share just prior to the litigation, for the purpose of being a named plaintiff).

4. **Public filings:** Any purchase or sale which could be part of a short-swing transaction under §16(b) must be ***reported to the SEC***, under §16(a). In fact, any §16(b)-style insider (i.e., officer, director, or 10%-owner) must file a statement showing his ownership in the company's stock within 10 days after any calendar month in which that ownership changes. The SEC releases this information to the public, and private securities lawyers scan it looking for §16(b) short-swing trades.

5. **Federal suit:** A §16(b) action must be brought in ***federal court***.

6. **Not complete solution to insider trading:** Observe that while §16(b) may catch someone who is not in fact trading on inside information, the converse is also true: a careful insider may avoid §16(b) even if he is blatantly trading based on inside information. For instance, if Prexy buys stock in XYZ Corp., of which he is president, on Jan. 2, based on the knowledge that the company will soon release favorable news, he will avoid §16(b) liability so long as he holds on to the stock until at least July 3.

C. **Who is an insider:** As noted, §16(b) covers only directors, officers, and more-than-10%owners.

1. **Who is an "officer":** Who is an ***"officer"*** for 16(b) purposes? Unlike the status of being a "director," there is no simple, universally-agreed-upon definition of "officer" for 16(b) purposes.

a. **Rule 3b-2:** The SEC's Rule 3b-2 under the '34 Act (applicable to §16(b) liability) defines "officer" as follows: "[A] president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated."

b. **Case law:** The case law on who is an "officer" for §16(b) purposes seems to boil down to these principles:

i. **3b-2 title:** Anyone who holds any of the titles listed in the first phrase of Rule 3b-2 (president, vice president,

secretary, treasurer, comptroller) is ***automatically*** an "officer" for 16(b) purposes.

ii. **Functional analysis:** In addition, even a person who does not hold one of the titles enumerated in Rule 3b-2 will still be deemed an "officer" if he ***in fact*** performs executive duties similar to those typically performed by a holder of one of the named titles. This is essentially the "functional" approach of the second phrase of Rule 3b-2. Thus even someone who holds the title of, say, "production manager" might be an "officer" under §16(b), if it were demonstrated that he was essentially an executive-level worker who would be likely to obtain material confidential information about the company's affairs in performing his job.

2. **Who is a "beneficial owner":** Even tougher issues are involved in determining who is "directly or indirectly the ***beneficial owner*** of more than 10%" of some class of the company's stock. (§16(a), incorporated by reference in §16(b).)

a. **10% of any class:** First, it's important to remember that a person falls within §16(b) if he owns 10% or more of ***any class*** of the company's stock — he need not own 10% of the total equity in the company. For instance, if the company's equity is divided into 1,000,000 shares of common stock and 1,000,000 shares of preferred stock, D will be covered by §16(b) if he owns 100,001 shares of preferred.

b. **Attribution:** Remember that a person is covered under the "owner" prong of §16(b) if he is "directly or ***indirectly*** the beneficial owner.…" Therefore, the court will sometimes ***attribute*** stock listed in A's name as being "indirectly beneficially owned" by B. The consequence of this attribution will be that A and B are treated as one "person," so that: (1) a sale of stock listed in A's name might be matched against a purchase in B's name; or (2) a purchase and sale of stock in A's name may come within §16(b) because B is a director or officer of the company even though A is not. Probably most courts would agree to the following general attribution

principles:

i. Spouse and minor children: A person will generally be regarded as the beneficial owner of securities held in the name of his or her ***spouse*** and their ***minor children***. See SEC Exchange Act Release No. 7824 (1966) (applying to the disclosure requirements of §16(a), but probably relevant to 16(b) as well). Attribution is especially likely where the spouses ***share the economic benefit***, and/or one spouse ***influences*** or controls the other's investment decisions.

ii. Grown children: But a parent is less likely to have attributed to him the stock ownership of his ***grown children***.

3. Deputization as director: A corporation may be treated as a "director" of another corporation if the former appoints one of its employees to serve on the latter's board.

Example: ABC Corp owns a significant minority interest in XYZ Corp. ABC appoints E, its employee, to serve on the board of XYZ. ABC will be deemed to have "deputized" E to serve as director, so ABC will be treated as a constructive director of XYZ, and any short-swing trading profits reaped by ABC in XYZ stock will have to be returned to XYZ.

D. When must the buyer/seller be an insider: To be covered by §16(b), must one be an "insider" (i.e., a director, officer, or beneficial more-than-10% owner) at ***both*** the time of purchase and the time of sale? The answer varies depending on whether the trader's insider status comes from his being an officer or director, on the one hand, or an owner, on the other.

1. Director or officer at only one end of swing: If D is a ***director or officer*** at the time of ***either*** his sale or his purchase of stock, §16(b) applies to him even though he does not have the status at the other end of the trade. C&E, p. 963-64.

2. 10% ownership: But the rule for 10% owners is different. Notice that under the last sentence of §16(b), the entire section does not apply to any transaction "where such beneficial owner

was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved.…" So it is clear that a person is caught by the "10% owner" prong of 16(b) only if he has that more-than-10% status at ***both*** ends of the swing. But the interesting questions are: (1) Do we count the purchase that puts the person over 10%? and (2) Do we count the sale that puts the person under 10%?

a. **Purchase that puts one over 10%:** It is clear that the ***purchase*** that puts a person ***over*** 10% does ***not*** count for 16(b) purposes. In other words, a particular purchase will not be the first part of a buy-sell short-swing unless the buyer ***already owned more than 10%*** before the purchase. To put it another way, the purchase that ***lifts the buyer over 10%*** cannot be matched against a subsequent sale within six months. The Supreme Court so held in *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232 (1976).

   i. **Rationale:** This rule makes sense, because we are trying to prevent people from buying on inside information and then reselling soon after; a person who at the moment he decides to buy does not yet own 10% is not an insider at the moment of decision, and thus presumably has no special information on the company's affairs. Clark, pp. 297-98.

b. **Sale that puts person below 10%:** But now consider the converse problem: suppose D already owns more than 10%, makes an additional purchase on Feb. 1, and then sells such a big chunk on March 1 that that sale brings him below 10%. Can the March 1 sale be partially matched against the Feb. 1 purchase, or do we measure D's 10% ownership status after the sale? This question ***has not been definitively resolved.*** However, the anti-insider-trading rationale of §16(b) suggests that we should do this measurement ***before*** the sale — at the moment D ***decides*** to make the sale, he is still a more-than-10%-owner, and presumably has access to inside information about the company. See Clark, p. 298.

   i. **Two sales:** Suppose D owns, say, 13% of XYZ Corp.,

and within six months of acquiring it, cleverly makes not one but ***two sales*** to dispose of his interest: first a sale of 3.5%, and then a sale of the remaining 9.5%. D will of course argue that his only §16(b) liability is as to the initial 3.5% sale, and that since he no longer owned 10% at the time of the second sale, it is exempt. The Supreme Court ***agreed*** with this argument, over P's objection that both sales should be covered if they were part of a common design or plan, in *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418 (1972).

E. What is a "sale," in the case of a merger: If the corporation ***merges into another company*** (and thus disappears), the insiders will not necessarily be deemed to have made a "sale" for purposes of §16(b). D will escape short-swing liability for a merger or other unorthodox transaction if he shows that: (1) the transaction was essentially ***involuntary***; *and* (2) the transaction was of a type such that D almost certainly did ***not have access*** to inside information.

Example: Raider launches a hostile tender offer for Target. On Feb. 1, Raider buys 15% of Target pursuant to the tender offer. Target then arranges a defensive merger into White Knight, whereby each share of Target will be exchanged for one share of White Knight. The merger closes on May 1, at which time Raider (like all other Target shareholder) receives White Knight shares in exchange for his Target stock. On June 1, Raider sells his White Knight stock on the open market for a total greater than he originally paid for the Target stock.

Raider does not have any §16(b) problem, because the overall transaction was essentially involuntary, and was of a type in which Raider almost certainly did not have access to inside information about White Knight's affairs.

F. Computation of profits: If §16(b) applies, the defendant insider must forfeit to the corporation his "profit" realized by the purchase-sale or sale-purchase transactions. In the case of multiple purchases or sales within a six month period, the concept of "profit" is ambiguous. But what courts have in fact done is to perform the calculation so as to produce the ***maximum possible profits***.

1. **Lowest purchase price matched against highest sale:** In other words, the court will take the shares having the ***lowest purchase price*** and match them against the shares having the ***highest sale price***, ***ignoring any losses*** produced by this method. In other words, the courts do ***not*** match stock certificate numbers to determine the profits produced by the sale of particular shares (as they would do in a tax case). Nor do they use, say, a first-in-first-out computation, as an accountant might.

2. **"Profit" under §16(b) despite overall loss:** This means that, paradoxically, an insider may have to fork over "profits" in a §16(b) suit ***even though he had an overall loss*** in his transactions during the six-month period.

   Example: D is a director of XYZ Corp. He engages in the following sales and purchases of XYZ stock:

Transaction	Price	Date
Buy 200	$10	Feb. 1
Sell 200	$5	March 1
Buy 100	$20	April 1
Sell 100	$15	May 1

   Assuming that D never owned any other XYZ shares, a tax or accounting computation would conclude that D lost $1,500 on these transactions in total: he lost $1,000 on the first 200 shares, and another $500 on the last 100 shares. But in a §16(b) case, the court would match 100 of the 200 shares bought at $10 against the 100 shares sold for $15; this would produce a $500 "profit," which D would have to surrender to XYZ despite his real loss on the set of transactions! See Clark, p. 300, fn. 17.

3. **Consequence:** Therefore, as a practical matter, if an insider makes a sale within six months of a purchase, or a purchase within six months of a sale, he does so only at his ***great peril.***

Quiz Yourself on
INSIDER TRADING (AND RELATED TOPICS) *(SHORT-SWING TRADING PROFITS)*

69. Joker is the president of the Metropolis By-Products Company, whose shares are publicly traded. Joker buys 11,000 Metropolis shares at $10 each on March 15. The by-products business is booming, and the shares are trading at $15 by June 1. On that fateful day, Joker trips on a catwalk at the factory and falls into a vat of chemicals. His ensuing medical bills are enormous, compelling him to sell 1,000 of the shares for $15 each on June 15. At the moment he sells the shares, Joker doesn't know anything about the company's operations that the general public doesn't know.

(a) You represent Robin, who owns a small number of Metropolis shares. What federal securities claim might you make against Joker?

____

(b) Will your claim succeed? _____________________________

(c) Assuming the claim succeeds, how much will you recover, and to whom will it go? _____________________________

70. Fairy Godmother decides she's a real bozo for making wishes come true for nothing. As a result, she incorporates under the name Magic Wand, Inc., and begins taking on Fairy Godmother trainees, whom she teaches to perform miracles. The company grows by leaps and bounds, until it has sales of $100 million annually and has shares traded on the NYSE. Fairy Godmother owns 15% of Magic Wand's common stock. On March 1, she buys another 5,000 shares of the common stock at $10, and sells 1,000 shares at $15 on April 1. On May 1, Rex Judicata, a lawyer, reads about these transactions. On June 1, he buys 50 shares of Magic Wand stock, and immediately pursues a derivative claim on Magic Wand's behalf, seeking Fairy Godmother's profit under §16(b). Does Judicata have standing to pursue the claim? _____________________________

71. Ariel, believing that seaweed is likely to become a major food source, buys 5,000 shares of publicly traded Little Mermaid Sea Harvests, Inc., on March 1. The shares cost $5 each, and her 5,000 shares represent 5% ownership of Little Mermaid. Ariel has no other connection with Little Mermaid. On April 1, Ariel buys another 10,000 shares at $5. On May 1,

the U.S. government announces substantial government support for seaweed-based food products. Little Mermaid stock soars to $15 a share, prompting Ariel to sell her 15,000 shares on May 2. A §16(b) claim is filed against Ariel. How much, if anything, will Ariel owe?

____

72. Calvin buys 1,000 shares of Hobbes Fantasy Vacations, Inc. stock at $10 a share on May 1. On June 1, Calvin is elected to Hobbes's board of directors. On July 1, he sells his 1,000 shares for $15 apiece. A 16(b) claim is filed against him. Will Calvin be liable under §16(b)?

____

73. Albert Einstein is president of the Gone Fission Toy Company, which makes nuclear-powered toys. Gone Fission's stock is traded on the NYSE. On April 1, Einstein buys 500 shares of Gone Fission at $11 each. On May 1, he sells 500 shares at $8 each. On June 1, he buys 1,000 shares at $5 each. On July 1, he sells 1,000 shares at $6 each. If Einstein is sued under §16(b), how much, if anything, will he owe to Gone Fission? _____________________________

Answers

69. **(a) A claim under §16(b) of the '34 Act, to recover short-swing trading profits.** Under this section, if an officer (or director or 10% owner) of a publicly-traded company buys and then sells (or sells and then buys) the company's stock within a 6-month period, all profits must be paid over to the company. [305]

(b) Yes. Joker, as president, is obviously an officer of Metropolis. Since he bought shares on March 15, and sold 1,000 of them on June 15 (less than 6 months after purchase), he's automatically liable under §16(b). The fact that he had no actual insider knowledge is irrelevant.

(c) $5,000, payable to Metropolis. The computation is simple, in this instance: on the 1,000 shares Joker sold, he made a profit of $5 per share, so he must disgorge the entire $5,000 profit to Metropolis. However, the plaintiff's lawyer will be entitled to reasonable attorney's fees out of this sum, with the corporation receiving only the balance. [306]

70. **Yes; if the corporation itself doesn't pursue a §16(b) claim against an insider, any shareholder can do so, regardless of when he became a shareholder.** [306] Thus, the fact that Judicata wasn't a shareholder either at the time Fairy Godmother made her purchase or at the time she made her sale doesn't matter. Note that the lack of any "advance purchase" requirement gives attorneys an incentive to keep up with trades by insiders: such trades have to be reported to the SEC, and are then publicly disclosed. So an attorney can view the public record to spot a §16(b) violation, buy a few shares (or have a friend buy shares) in the corporation in question, press a §16(b) suit derivatively, and collect attorney's fees.

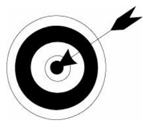
71. **$0.** §16(b) makes certain people engaging in purchases and sales of a corporation's securities within six months liable to pay any profits on those transactions to the corporation. The people covered are directors, officers, and 10+% shareholders. The issue here is whether Ariel fits the 10+% shareholder profile, since she was a 15% owner when she sold her shares. The answer is "no" — the Supreme Court has held that the purchase that *lifts* a person over the 10% threshold does not itself count under §16(b). [308] Since Ariel didn't make a later purchase (i.e., a purchase at a time when she already owned 10%+ of any class of stock), there's nothing against which the May 2 sale can be matched, so Ariel has no liability.

    RELATED ISSUE: Say that, instead of selling shares on May 2, Ariel bought another 1,000 shares at $15. On May 15, suppose she sold all her 16,000 shares at $20. 1,000 shares of the 16,000-share sale could be matched against her May 2 purchase, since she was a 10+% owner immediately before that purchase. As a result, she could be required to surrender $5,000 of her profit (1,000 x [$20-$15]) to the corporation under §16(b).

72. **Yes.** §16(b) prohibits in-and-out purchases and sales of corporate securities by insiders, who can be directors, owners, or 10+% shareholders of the issuer. As the previous question shows, 10%-owners won't be covered unless they occupy that status both at the time of purchase and the time of sale. But the rule is different for directors or officers: these are covered by §16(b) if they hold that director or officer status at *either* the time of sale *or* the time of purchase. [308] Since

Calvin was a director at the time he sold the 1,000 shares, he's liable under §16(b) (and will have to pay his $5,000 profit over to Hobbes).

73. $2,000. This is true even though Einstein lost $500 overall on his trades during the 6 months! §16(b) makes insiders (and a President, as an officer, is clearly an insider) liable to the corporation for short-swing profits from trading in the corporation's stock. The court will match purchases and sales according to a *lowest-in*, *highest-out* formula, and will consider only those matches that produce profits. [309] Here, Einstein's "lowest in" is the 1,000-share lot he bought June 1 at $5. His "highest out" is May 1, when he sold 500 shares at $8. Matching 500 of the June 1 purchase against the May 1 sale results in a $1,500 profit (500 x $3). His next "highest out" is the 500-share sale at $6 on July 1; matching this sale against the remaining 500 shares from the June 1 purchase (at $5) results in a $500 profit (500 x $1). Any matching that produces a loss is ignored. Thus, Einstein's "profits" within a six month period are deemed to be $2,000, which he owes to the corporation.



***Exam Tips** on*
INSIDER TRADING (AND RELATED TOPICS)

Be alert to insider trading whenever a fact pattern involves the purchase or sale of stock based on ***information which was not available to the general public***.

☛ First, check for the core insider-trading scenario: a corporate insider has learned something non-public that will affect the price of the stock, and he then ***either buys or sells before the info becomes public.*** The insider has violated ***SEC Rule 10b-5.*** First, he can be sued civilly by the SEC. Second, ***any private person*** who has traded in the stock at a less favorable price during the time the insider was trading has an ***"implied private right of action"*** under federal law, and can therefore recover civil damages from the insider.

Example: D is a director of J Corp, a public company. He learns that J has

developed a major new invention which it's about to patent, that will make the corp. more valuable. At a time when the public doesn't know about the invention, D buys J Corp. stock on the stock exchange, at $25/share. When J announces the deal, the stock goes to $50/share, and D sells. Both the SEC, and anyone who sold stock during the approximate time when D was buying, can bring a civil action against D. (Also, D has committed a crime.)

- ☞ Check to make sure that the private plaintiff ***bought or sold*** after the insider had the inside info. If not, P can't recover.

  Example: Prexy says that Corp.'s earnings will be down next quarter. Prexy knows that in fact the earnings will be sharply up, and Prexy is in fact buying secretly for his own account. Joe shows that he would have bought had Prexy remained silent, but he declined to buy because of Prexy's false statement. Joe can't recover against Prexy under 10b-5, because only those who sell or buy while the insider is trading can recover.

  - ☞ Remember that this "buy or sell" requirement means that the ***corporation itself cannot recover*** for insider trading under 10b-5, unless it was itself a purchaser or seller of shares at the same time as the insider trading was going on. (*Example:* On the facts of the above example, Corp. can't recover under 10b-5 against Prexy, if Corp. didn't issue any of its own shares while Prexy was buying.)

☛ Remember that the inside info must be ***"material."***

- ☞ You're most likely to have a materiality issue when the inside info is that ***merger negotiations have begun,*** but are very ***preliminary***. If all that's happened is that another company has approached, say, the target's CEO but the CEO has told them he's probably not interested, that may not yet be "material" inside info. (But once the CEO has decided to try to make a deal, and certainly once the CEO has gotten the board of directors involved in whether to sell, the info *is* now material.)

☛ Also, remember that the info must be truly ***"non-public."*** It's not enough that the other party to the transaction doesn't know of it — if a substantial number of members of the public do know of it, there can't be 10b-5

liability.

Example: Corp., a privately-held company, has just announced its new quarterly earnings, which are good. Prexy, Corp's president, buys stock from Pete in a face-to-face transaction. Pete hasn't heard the earnings report yet, but Corp. has already sent a press release to several local newspapers containing the info. The info isn't "non-public," so Prexy hasn't violated 10b-5.

- ☛ Keep in mind that 10b-5 also applies to ***private sales*** of ***non-publicly-traded stock*** based on insider info.
  - ☞ But a ***facility of interstate commerce*** (phone, mail or a national securities exchange) must be used for any 10b-5 violation. This jurisdictional requirement is sometimes missing in private-sale fact patterns. (*Example:* Prexy buys stock directly from Dupe in a face-to-face transaction. Even if Prexy had insider info, there's no 10b-5 violation.)
- ☛ A large portion of 10b-5 questions turn on whether and when there's ***tipper liability*** and ***tip-pee liability***.
  - ☞ The tipp***er*** can be liable, ***even if he doesn't personally benefit,*** if he ***intends to make a pecuniary gift to the tippee.*** (*Example:* Prexy, head of Oilco, tells Fred, his friend, "We just struck a large well, so you might want to buy some stock quickly." Fred buys lots of stock, which rises after Oilco releases the news. Prexy is liable even though he did not buy or sell, and didn't get — or desire — any personal financial gain from tipping Fred; it's enough that he desired to confer a financial benefit on Fred.)
  - ☞ Most importantly of all, the tipper is generally ***not liable unless he is an "insider"*** of the ***issuer.*** Normally, an insider is one who ***works for, or is a director of,*** the issuer (the company whose shares are bought or sold).
    - ☞ But ***non-employees*** can be ***constructive insiders.*** Thus ***lawyers***, investment bankers, accountants, etc., can be insiders if they've been given the info by issuer, to enable them to perform tasks on the issuer's behalf.
    - ☞ Someone who ***stumbles upon*** the inside info ***without having a***

fiduciary duty regarding that info is ***not*** an insider, and can't be liable as a tipper (or as a tippee). (*Example:* While sitting on a commuter train, D overhears Prexy, who he knows to be head of Oilco, tell Friend, "We just brought in a huge gusher today." If D tells E to buy Oilco stock, and E does so, neither D nor E is liable under 10b-5, because D didn't have any fiduciary duty regarding the info and thus isn't an "insider.")

☞ When the inside info is news of an impending takeover, a person who works for or controls the ***bidder*** is ***not an "insider" of the target.*** (*Example:* Prexy, head of Bigco, is planning to have Bigco make a tender offer for Smallco. If Prexy personally buys shares in Smallco before announcing the tender offer, there's no 10b-5 violation, because Prexy is not an insider of Smallco, the issuer. Same result if Prexy tips Friend and Friend buys. But make sure Prexy is not a "misappropriator," as explained in the next paragraph.)

  ☞ But remember that under the ***"misappropriation"*** theory, one who is an ***"outsider"*** (vis a vis the issuer) can still be a tipper, if he steals the information and trades on it or passes it on. (*Example:* Veep is a Vice President at Bigco, which is planning to make a tender offer for Smallco. Veep knows or should know that this information is secret and proprietary to Bigco. If Veep buys Smallco shares, he's liable under 10b-5 as a "misappropriator." If Veep passes on the info to his friend Leonard, who buys, Veep and Leonard are probably both liable, as tipper and tippee respectively.)

☞ The tipp***ee***'s liability is ***derivative from the liability of the tipper*** — if the conditions for tipper liability aren't satisfied, the tippee can't be liable no matter what the state of his knowledge or intent. (*Example:* On the earlier Prexy-Friend example, this principle is why Friend isn't liable under 10b-5 if Friend buys after being tipped by Prexy.)

☞ Even if the tipper is liable, the ***tippee won't*** be liable unless he ***knew or should have known*** that the tipper was ***breaching a fiduciary obligation*** to the corp. whose shares were traded.

Example: Joe is a carpet installer. While installing carpet at the house of Prexy, head of Oilco, he sees an Oilco memo on Prexy's desk saying, "We just struck a huge gusher." Joe tells Fred, his friend, "You should buy Oilco stock right away, because I heard they just struck oil," but doesn't tell Fred how he learned the info. *Joe* is liable as a tipper [he knew he was breaching a fiduciary duty to Oilco and Prexy by stealing the info, and he intended to confer a benefit on Fred]. But *Fred won't* be liable as a tippee, since he didn't know, and had no reason to know, that Joe got his info as a result of a fiduciary breach.

- ☛ Next, consider the possibility that there may be a ***state-law*** cause of action for the insider trading.
  - ☞ If all the insider did was to silently, and impersonally, buy or sell ***on a stock exchange*** while in possession of the information, there's probably no state-law (just federal law) liability.
  - ☞ But if the insider buys ***face to face*** with someone (call him X), X may be able to recover against the insider under state common-law principles if either:
    - ☞ The insider made an ***affirmative misrepresentation.*** (*Example:* Insider says to P, "I'll sell you my stock at $15/share; the company will be reporting a good quarter soon and the stock will go up." In fact Insider knows that the quarter will be bad, and the stock goes down. P will probably be able to have the transaction rescinded and/or get damages.) ***or***
    - ☞ The insider remains silent, but ***uses unfair methods*** to seek out a buyer or to ***conceal his own identity.*** This is the ***"special facts"*** doctrine. (*Example:* Pres. has inside info that Corp's earnings will go up. Pres. has a broker locate X, a stockholder in Corp., and has the broker buy shares from X without disclosing that he's acting for Pres. A state recognizing the "special facts" doctrine will probably let X rescind the transaction or get damages.)
  - ☞ Consider the possibility that the ***corp. itself*** may be able to bring its own state-law action against the insider-trader, to recover on behalf of all s/h's the profits the trader made. Say that the NY case of *Diamond*

v. Oreamuno would allow corp. recovery here, but that most states do not. (*Example:* On above example, Corp. could recover from Pres the profits Pres made on the trade with X, under *Diamond*. This is true even though Corp. itself didn't suffer any direct loss — only X had direct losses, from selling his shares at a low price.)

☛ Finally, be on the lookout for situations in which an insider may be liable for ***short-swing profits.*** Remember that under §16(b) of the Exchange Act, a corp. which is traded on a ***national stock exchange*** can recover ***profits made by a director, officer or more-than-10% s/h*** from the ***purchase-and-sale***, or the ***sale-and-purchase***, of that corp's securities ***within any 6-month period.***

☞ Remember that there's no §16(b) cause of action unless there's been ***both a purchase and sale within the same 6-month period.***

Example: On Feb. 1, Prexy, head of Corp., sells 1,000 shares of Corp. stock at $25. On March 1, Corp. discloses poor earnings, and the stock immediately falls to $10. If Prexy doesn't buy any stock back until Dec. 1, there's no 16(b) violation. But if he buys back 500 shares on July 1 at $10, he's automatically liable to Corp. for $15 × 500, regardless of whether he had any insider knowledge on either Feb. 1 or July 1.

☞ If D is a ***s/h*** (but *not* an officer or director), be sure that she was a ***more-than-10%*** s/h when she acquired the stock. §16(b) won't apply to a s/h unless she owned more than 10% of the corp's stock at both the time of purchase and the time of sale. ***The purchase that lifts the buyer over 10% does not count*** for §16(b) purposes.

Example: Prior to Dec. 1, Acquirer Corp. owned 50,000 shares (5%) of Target Corp. On Dec. 1, Acquirer buys an additional 140,000 shares (14%) of Target for $10/ share, thereby becoming a 19% s/h in Target. On Feb. 1, Acquirer sells all its shares in Target for $20/share. Acquirer has no §16(b) liability, because there never was a time when it made a purchase while already — before the purchase — a 10% holder. (As to the sale, it's not clear whether we evaluate the 10% status before or after the sale, but there's a good chance that we measure that status *before* the sale.)

☞ However, where D is a ***director***, §16(b) applies as long as he occupied that position on ***either*** the purchase date ***or*** sale date. Therefore, be alert for situations where the director ***resigned or was removed*** from the board before selling the stock, since these are ***covered***.

Example: D is a director of X Corp, a publicly-traded corp. with 100,000 shares outstanding. On March 1, D (who owns no X stock) buys 1,000 shares at $10. On July 1, D is removed from his seat for cause, on account of unauthorized expenses he charges to the company. On July 15, D sells his 1,000 shares at $15. X can recover $5,000 from D under §16(b), because D was a director at the time of the purchase, and it doesn't matter that D was no longer a director at the time of sale.

☞ When you calculate profits for §16(b), remember that the ***lowest purchase price is matched against the highest sale price,*** so as to ***maximize*** the corp's recovery. (Stock certificate numbers are not matched up, in other words.)

Example: D, a director of X Corp., buys 4,000 shares of X at $25 on Feb. 1. On March 1, D exercises an option to buy 1,000 shares at $15. On June 1, D sells 1,000 shares (whose certificates show that they were part of the 4,000-share lot), for $20 per share. X can recover $5,000 from D ($5 × 1,000), because we ignore the actual share certificates and match the lowest purchase price against the highest sale price.

1. The plaintiff may be either a private person or the SEC. For the elements that must be satisfied by a private plaintiff in a damages action, see *infra*, p. 283.

2. Under the "misappropriation theory" recognized by the Supreme Court, it's enough if D is in a fiduciary relationship with *someone other than the issuer* (e.g., a company planning a tender offer for the issuer). See the discussion of the misappropriation theory and *U.S. v. O'Hagan, infra*, p. 291.

3. For more about this theory — which the entire Supreme Court finally accepted in 1997 — that "misappropriation" of the information from even a non-issuer is enough to trigger 10b-5 liability, see *infra*, p. 289.

4. In a post-*Ernst* decision, the Supreme Court ruled that there is *no private action for aiding and abetting* a violation of 10b-5. So the requirement of scienter is no longer of practical importance in private aiding-and-abetting suits against professionals, like *Ernst*, since these can't be brought at all. See *Central Bank of Denver v. First Interstate Bank of Denver*, *infra*, p. 282. (But scienter would still matter in an *enforcement* action brought by the SEC [see *infra*, p. 282] for aiding-and-abetting under 10b-5. Scienter would also still matter in a private direct [rather than aiding-and-abetting] insider-trading case, where the accusation was that the defendant traded while in possession of inside information [e.g., he thought the information was already public]. See *infra*, p. 282.)

5. Since the Supreme Court has now accepted the "misappropriation" theory, see *infra*, p. 289, it would be enough if Tipper breached a fiduciary responsibility to *Oil Co.* (his own employer) by making the disclosure, and it wouldn't matter that Oil Co. wasn't the issuer whose stock was being traded. But on our hypo here, Tipper is not violating any fiduciary obligation to Oil Co. (there's no indication that Oil Co. cares about whether Tipper keeps the info secret), so use of the misappropriation theory won't affect the outcome of the hypothetical.

6. But Bartender probably has criminal liability under some *non-10b-5* federal statute(s), such as the wire-fraud statute (if he uses the telephone to place the buy order.) See p. 290.

7. Private class actions may be brought in insider-trading cases, too, but their biggest impact has been in misrepresentation cases not involving insider trading.

CHAPTER 9

SHAREHOLDERS' SUITS, ESPECIALLY DERIVATIVE SUITS

ChapterScope

This Chapter covers suits brought by shareholders, especially the "shareholder's derivative suit." Key concepts:

- **"Derivative suit" defined:** A shareholder's derivative suit is a suit in which the shareholder sues "on behalf" of the corporation, on the theory that the corporation has been injured by the wrongdoing of a third person, typically an insider. (*Example:* A suit brought against an officer for engaging in self-dealing transactions with the corporation.)

- **Differences:** It's important to distinguish between when a suit should be brought as a derivative suit, and when it should be brought as an ordinary ***"direct"*** suit. Suits for breach of the ***duty of care*** and of the ***duty of loyalty*** are normally ***derivative***. Suits by a ***minority holder*** contending that the majority holder has behaved unjustly towards P (e.g., by refusing to pay dividends) are typically direct suits.

  - **Why distinguish:** The distinction between the two kinds of suits is important, because much more stringent ***procedural rules*** apply to derivative suits. (For instance, it's relatively easy for the board of directors to have the derivative suit discontinued if they don't think it has merit.)

- **Demand on board:** Most states require that before a derivative suit can be maintained, the plaintiff must make a ***"demand"*** on the board, in which he asks the corporation to take over the suit. If (as usually happens) the board declines, the court will often dismiss the suit.

  - **Demand excused:** But many states ***excuse*** the demand on the board in certain circumstances, such as where demand is likely to be "futile" (e.g., it's the entire board that's accused of wrongdoing, or of being

under the wrongdoer’s thumb).

- **Settlements:** Because there’s a big risk that the plaintiff and the corporation will collude, any ***settlement*** of a derivative action has to be ***approved by the court***.
- **Indemnification:** The corporation may sometimes ***reimburse*** (***indemnify***) the director or officer for losses incurred relating to her actions on the corporation’s behalf. In some situations, the corporation is ***required*** to indemnify, whether it wants to or not (***“mandatory”*** indemnification) and in others, the corporation ***may*** indemnify if it wishes to, but need not (***“permissive”*** indemnification).

I. INTRODUCTION

A. Remedy for fiduciary breaches: What happens when a person who owes the corporation a fiduciary duty breaches that duty? For instance, if X breaches his duty of loyalty to the corporation, or his duty of care to it, how can the corporation be made whole? In theory, the corporation itself, by vote of its board of directors, could decide to bring suit against the wrongdoer. But the wrongdoer will normally be an insider — a director, officer, or controlling shareholder — and the wrongdoer’s fellow insiders will normally be reluctant to turn on one of their own.

1. **The derivative suit:** Therefore, courts in the United States (as well as in other common-law countries) have long allowed a peculiar form of action in order to deal with this problem: the ***shareholder’s derivative suit***. In a shareholder’s derivative suit, an individual shareholder (typically an ***outsider***) brings suit ***in the name of the corporation***, against the individual wrongdoer.
2. **Suit against insider:** The derivative suit may in theory be against anyone who has wronged the corporation, whether that person is an insider or outsider. Thus the defendant might be an officer who has breached the duty of due care or the duty of loyalty, or it might be an outsider who has injured the corporation in some other way (e.g., by breaching a contract with

it, by committing a tort against it, etc.) But because the corporation itself, by vote of its board of directors, will usually not have any special reluctance to pursue claims against outsiders, the particular utility of the derivative suit is to pursue claims on the corporation's behalf against ***insiders.***

a. **Breach of loyalty:** Most significantly, claims can be brought against an insider who has caused the corporation to enter into a ***self-dealing transaction*** with him (e.g., a sale of corporate property at below fair market value) or against an insider who has usurped a ***corporate opportunity*** (see *supra*, p. 219).

b. **Breach of due care:** Derivative suits are also brought, though typically with less success, based on the insider's alleged violation of his duty of ***due care***. For instance, if Corporation's board of directors vote to acquire all of the stock of Small Corp., and the acquisition turns out to be disastrous, a shareholder might bring a derivative action against the individual directors who approved the transaction, alleging that they failed to use due care in making the acquisition.

B. **Pros and cons of derivative actions:** The entire area of derivative actions is a highly controversial one — strong arguments can be made both in favor of and against such suits.

1. **Favoring suits:** Those who find a lot of value in derivative suits, and who therefore argue for court rules that make it relatively easy to file and pursue such suits, make the following arguments:

a. **Remedy for insider wrongdoing:** Such suits are practically the ***only effective remedy*** when ***insider wrongdoing*** occurs. The corporation itself (as represented by its incumbent board of directors) will rarely take action against an insider. The discipline of the marketplace (e.g., a decline in the market price of the company's stock when insiders are wronging the corporation) does little to deter wrongdoing, especially among insiders who own very little of the company's stock. Only an action brought by a shareholder whose investment has been

made less valuable because of the wrongdoing will directly redress the injury to the corporation.

b. **Deterrent effect:** A successful, or even threatened, derivative suit will have a useful ***deterrent*** effect — not only will the particular wrongdoer and the particular corporation in whose name the suit is brought be chastened, but potential wrongdoers in ***other*** corporations will think twice, lest they face the same kind of action.

c. **Legal fees:** The enforcement action is generally ***without direct cost*** (including attorneys' fees) to the corporation, since the plaintiff's attorney will only receive fees if he is successful, and he will then receive these fees only out of the recovery that is made on behalf of the corporation. (See *infra*, p. 339.)

2. **Against derivative suits:** But opponents of derivative suits make equally cogent arguments:

a. **Waste of corporation's time:** The mere prosecution of a derivative suit often ***wastes a lot of the time*** and energy of the corporation's senior executives, and any resulting benefit to the corporation is less than the value of this time and energy.

b. **Risk-averse managements:** Corporate managements will so fear derivative suits that they may become needlessly ***risk-averse***, and may thereby fail to maximize shareholder wealth.

c. **Strike suits:** Because of the large waste of senior management time when a suit continues through trial, management will often be tempted to ***settle*** even suits that have little merit, in order to be rid of them. This incentive to settle in turn gives the plaintiff's lawyers an incentive to bring ***"strike"*** or ***"nuisance"*** suits, i.e., suits that have little probability of succeeding on the merits but are troublesome enough to induce the corporation to make a settlement. In the end, only the plaintiff's lawyers, not the corporation, are enriched.

3. **Early termination:** Most states recognize merit on each side of

the controversy. Therefore, most states attempt to allow meritorious suits to be filed and to proceed to trial, while at the same time attempting to screen out suits without merit. The principal way this screening now occurs in most states is by allowing the corporation to appoint a special ***independent committee*** to assess the merits of the plaintiff's suit, and to recommend whether the suit should be continued or dismissed; if the committee is truly independent, conducts its investigation carefully, and recommends that the suit be discontinued, most courts accord that recommendation significant weight. The early termination of meritless derivative suits is the single most important issue in connection with derivative suits, and is discussed extensively beginning *infra*, p. 325.

II. DISTINGUISHING DERIVATIVE FROM DIRECT SUITS

A. General distinction: Not all suits by shareholders are derivative — in some situations, a shareholder (or a class of shareholders) may sue the corporation, or insiders, ***directly***. The procedural and substantive rules that govern direct actions are quite different from those that govern derivative actions. How, then, can we distinguish between an action that should be characterized as a derivative action and one that should be characterized as a direct action?

1. **General rule:** In the most general sense, the distinction is based on ***who has been directly injured***: if the injury is an injury ***to the corporation***, the suit to redress it is a derivative action; if the injury is to some or all shareholders, the suit is a direct one. See the discussion of *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, the Delaware case on the distinction, *infra*, p. 320.

2. **Illustrations of derivative action:** Thus most cases brought against insiders for breach of the fiduciary duty of ***care*** or ***loyalty*** are ***derivative***. Here are some examples:

   a. **Due care:** A suit against the board members for failing to use ***due care*** in overseeing the company's operations (e.g., by

grossly negligently approving a disastrous acquisition);

b. **Self-dealing:** A suit against an officer for ***self-dealing*** (e.g., by inducing the corporation to buy the property from him at an above-market price);

c. **Excessive compensation:** A suit to recover ***excessive compensation*** paid by the corporation to its officers;

d. **Corporate opportunity:** A suit against an officer alleging that he has usurped a ***cor-porate opportunity*** for himself (e.g., by acquiring a piece of property that the corporation would have been interested in).

See Clark, p. 663.

Note: Observe that in each of these above situations, it can be said that the shareholders have been injured, since their investment in the corporation is worth less than it would have been had there been no breach of duty. But the action is still a derivative, not direct, one because ***in the first instance*** it is the ***corporation*** that has been injured, and the shareholders have only been harmed secondarily.

3. **Illustration of direct actions:** Here, by contrast, are some of the types of suits that are generally held to be ***direct***:

a. **Voting:** An action to enforce the holder's ***voting rights***, or to prevent some other shareholder from improperly voting his shares;

b. **Dividends:** An action to compel the payment of ***dividends***;

c. **Anti-takeover defenses:** An action to prevent management from improperly using the corporate machinery to ***entrench itself*** (e.g., a suit to enjoin the corporation from enacting a "poison pill" which would prevent a takeover);

d. **Inspection:** An action to compel the ***inspection*** of the corporation's books and records.

e. **Protection of minority shareholders:** A suit to prevent oppression of, or fraud on, ***minority shareholders, especially***

where the corporation is closely-held.

See ALI Prin. Corp. Gov., Comment c to §7.01.

4. **Delaware law on the distinction (*Tooley*):** A 2004 Delaware case establishes a simple ***two-part test*** for distinguishing between direct and derivative actions. In *Tooley v. Donald-son, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004), the Delaware Supreme Court said that the issue must turn "solely" on the two following questions:

   [1] "who ***suffered the alleged harm*** (the corporation or the suing stockholders, individually)?" and

   [2] "who would ***receive the benefit*** of any recovery or other remedy (the corporation or the stockholders, individually)?"

   a. **Probably must meet both parts to be direct:** The *Tooley* decision does not focus on what happens if the two answers point in different directions. The most likely reading is that to be "direct," the suing stockholders must ***both*** have ***suffered the alleged harm*** *and* be in line to ***receive the benefit of any recovery***. In any event, a split-answer should rarely happen — if the plaintiff shareholders have suffered a harm that is not dependent on an injury to the corporation, it is presumably those shareholders, not the corporation as a whole, who will also get the benefit of any recovery.

   b. **Application to facts of *Tooley*:** The facts of *Tooley* illustrate how the two-part Delaware test will work. The Ps were former minority shareholders of brokerage firm DLJ. Prior to the events in question, this minority group owned 30% of the company, and AXA owned 70%. AXA as controlling shareholder put through a merger agreement in which all shares in DLJ — whether owned by AXA or the minority holders — would be exchanged for a mix of stock and cash in Credit Suisse, the acquirer. After the merger agreement was signed, the DLJ board agreed to give Credit Suisse extra time to cash out the minority shareholders. The minority shareholders sued the DLJ board (apparently consisting mostly

of AXA-nominated directors), alleging that the grant of extra time violated the directors' fiduciary duty to the minority holders.

i. **Held to be direct:** Applying the new two-question test, the Delaware Supreme Court quickly concluded that the action was ***not a derivative suit.*** There was no claim that the corporation (DLJ) had been injured by the delay — only the minority stockholders claimed to have been injured (by having to wait longer for their money). And if there was a recovery, it was clear that that recovery would go just to the minority holders.[1]

5. **Direct action preferred:** Because the procedural rules imposed in derivative suits (see *infra*, p. 322) are generally tougher for the plaintiff than in a direct suit, the plaintiff will usually ***prefer to have his suit characterized as direct*** rather than derivative.

B. **Consequences of distinction:** As noted, the plaintiff will usually want his action to proceed as a direct rather than derivative one. Here are some consequences that flow from a court's decision to treat an action as direct or as derivative:

1. **Procedural requirements:** If the action is ***derivative***, the plaintiff must jump through a number of ***procedural hoops*** merely to be able to proceed at all. For instance, he must satisfy the "contemporaneous ownership" rule (*infra*, p. 322), by which he must have been a shareholder at the time the wrong complained of occurred; similarly, he may have to comply with a ***security-for-expenses*** statute.

a. **No jury trial:** Plaintiff in a derivative action also will typically face ***trial rules*** that are less favorable to him than he would in a direct action. For instance, most states hold that a derivative action is ***equitable***, and that there is therefore no right to a ***jury trial*** on it.

2. **Demand on board; termination:** Second, the plaintiff in a derivative suit is much more likely ***to lose control*** of his action than where the action is direct. For instance, the plaintiff must

generally make a ***demand*** on the board of directors that it bring suit; the board of directors (or, increasingly, a special committee appointed by the board) may in most states investigate and recommend ***termination*** of the suit. The court will often respect this termination recommendation (see *infra*, p. 330), so that the plaintiff will simply not be allowed to proceed. In a direct action, by contrast, the plaintiff (or the plaintiff class) will get to proceed unless the defendant obtains a summary judgment, a much more difficult thing to get.

3. **Who gets recovery:** Finally, the distribution of the ***recovery*** is likely to be more attractive to the plaintiff in a direct than in a derivative suit. In a derivative suit, the recovery is always ***by the corporation***, and the plaintiff benefits only to the extent that his shares in the corporation (as well as the shares of everyone else) become more valuable due to the corporation's recovery. In a direct action, by contrast, the plaintiff may be able to put money directly into his own pocket. For instance, if P sues to compel the payment of a dividend, this money will be paid directly to him if he succeeds.

III. REQUIREMENTS FOR MAINTAINING A DERIVATIVE SUIT

A. Rules, generally: There are three main procedural requirements that, in most states, a plaintiff must meet in order to maintain a derivative suit: (1) P must have been a shareholder ***at the time of the acts complained of*** (the ***"contemporaneous ownership"*** rule); (2) P must ***still*** be a shareholder at the time of the suit; and (3) P must make a ***demand*** (unless excused) upon the board of the corporation, requesting that the board attempt to obtain redress for the injury the corporation has suffered.

B. Requirement of a shareholder: All states require that the plaintiff be a ***stockholder*** in the corporation on whose behalf the suit is brought. Before we look at the ***time*** at which the stock must be owned, let us first consider what is meant by "stockholder." The word means, essentially, "holder of an ***equity*** security" in the

company.

1. **Bondholders not covered:** In other words, a ***bondholder*** or other creditor may ***not*** bring a shareholder's suit. C&E, p. 1002.

C. **"Contemporaneous ownership" rule:** A key requirement is that P have owned his shares at the ***time of the transaction*** of which he complains. See ALI Prin. Corp. Gov., Reporter's Note 6 to §7.02. This is the ***"contemporaneous ownership***" rule.

1. **Federal rules:** For instance, in derivative suits brought in federal court, Fed. R. Civ. Pro. 23.1 requires that the complaint allege "that the plaintiff was a shareholder … at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law.…"

2. **Nearly universal requirement:** Nearly all states similarly impose this "contemporaneous ownership" requirement, most by statute but some by case law. See, e.g., MBCA §7.41 (the shareholder may not commence or maintain a derivative proceeding unless she "was a shareholder of the corporation at the time of the act or omission complained of.…").

3. **Rationale:** Two reasons are usually given for the contemporaneous ownership rule: (1) it discourages litigious people from bringing frivolous suits, since they can't look around for wrongdoing and then buy shares that will support standing; and (2) a person who buys after the wrong with knowledge of it may ***pay a lesser price***, and would thus receive a windfall if he obtains a corporate recovery. ALI Prin. Corp. Gov., Comment c to §7.02.

4. **Criticism:** But the rule is also frequently criticized, on the grounds that it screens out meritorious suits as well as frivolous ones, and screens out suits where there would be no unjust enrichment.

   a. **Illustration:** For instance, the contemporaneous ownership rule (in its traditional phrasing) would bar suit by P if he purchased the shares after the wrongdoing, ***even if neither P***

nor anybody else knew of the wrongdoing at the time of purchase. In this situation, P clearly did not buy in order to stir up litigation (since he did not know of the wrongdoing), and P would not be unjustly enriched by a successful suit (since he did not pay a lesser price to reflect the unknown wrongdoing).

i. **ALI allows:** For this reason, the ALI's *Principles of Corporate Governance* merely require that the shares be bought before the material facts of the wrongdoing were "publicly disclosed or were known by [the plaintiff]." See ALI Prin. Corp. Gov., §7.02(a)(1).

5. **"Continuing wrong" exception:** Partly because of these criticisms, courts sometimes use a number of techniques to avoid throwing the plaintiff out of court even though he did not buy until after the alleged wrongdoing took place. One such technique is by recognizing an exception for ***"continuing wrongs."*** Under this exception, P can sue to challenge a wrong that began before he bought his shares, but that ***continued after the purchase.*** C&E, p. 1029-30.

D. **The "continuing ownership" rule:** The plaintiff must ***continue*** to own the shares in the corporation not only at the time of suit, but right up until the moment of ***judgment***. In other words, P must continue to have an actual (even if tiny) economic stake in the outcome of the suit right until its conclusion.

1. **Involuntary merger:** Normally, this requirement does not have much bite — since even a one-share holding by the plaintiff will suffice, compliance with the requirement is rarely difficult for the plaintiff. But there is one situation in which the continuing-ownership rule does have real bite: the situation in which all shares in the corporation are involuntarily ***exchanged*** into cash or shares in a different corporation, as part of a ***merger*** transaction. Here, many courts ease the unfairness that would result from mechanical application of the continuing ownership rule — they allow the shareholders in the no-longer-existing corporation to bring a non-derivative suit against the

wrongdoers, or they allow the surviving corporation (or its shareholders) to bring suit. See ALI Prin. Corp. Gov., Reporter's Note 4 to §7.02.

E. **Demand on the board:** Virtually all states require that, as a general rule, the plaintiff must make a ***written demand*** on the board of directors before commencing a derivative suit; the demand asks the board of directors to bring a suit or take other corrective action to redress the wrongdoing. Only if the board refuses to act may the plaintiff then commence suit.

1. **Excuse:** However, many jurisdictions also ***"excuse"*** the demand requirement where such a demand would clearly be ***futile.*** For example, if the essence of P's claim of wrongdoing is that the entire board of directors personally benefited in a pecuniary way from the transaction which they approved, most courts would excuse the would-be plaintiff from demanding that the board in effect sue itself.

   a. **MBCA:** The MBCA requires a demand on the board in ***all*** cases. See MBCA §7.42(1). The shareholder must then normally wait 90 days after the demand, before suing (unless the board rejects the demand earlier). §7.42(2).

2. **Later treatment:** The requirement of a demand on the board, and the accompanying doctrine that demand is sometimes excused, have extraordinary importance in the law of derivative actions. The reason for this is that in most states, the distinction between cases in which demand is required and those in which it is excused determines the ***scope of judi-cial review*** of the action: if demand is required and the board rejects the demand, the court will only very rarely allow the action to proceed; but if demand is excused, although the court may still terminate the action on the corporation's motion it is less likely to do so. Therefore, our treatment of the demand requirement is deferred until our treatment of the broad issue of early termination, *infra*, p. 325.

F. **Demand on shareholders:** Many states purport to require that the plaintiff also make a demand on the ***shareholders*** before he institutes the derivative suit. In theory, the shareholders would then

vote on whether to maintain the derivative action, and if a majority voted against the action, the plaintiff would not be permitted to proceed.

1. **Some courts eliminate requirement:** But a number of important jurisdictions do ***not*** require a demand on shareholders in ***any*** situation. This is true, for example, in California (Cal. Corp. Code §800) and New York (N.Y. B.C.L. §626). The trend is ***away*** from requiring shareholder demand; for instance, the ALI's Prin. Corp. Gov. §7.03(c), and Subchapter D of the MBCA both eliminate the demand on shareholders.

2. **Demand excused:** Even in those states that purport to require a demand on shareholders, the demand may be ***excused*** in a variety of situations. Usually, these demand-excused situations are so common that they virtually swallow up the requirement of a shareholder demand, so that the requirement has little practical bite. Here are some of the common grounds for excusing shareholder demand:

   a. **Large number of holders:** The number of shareholders is large enough that a demand would be very expensive or would result in substantial delay. This exception exists in almost every state with a shareholder-demand requirement, and as a practical matter ***eliminates*** shareholder demand in the case of ***any publicly-held corporation***.

   b. **Defendant controls:** The defendants have a ***majority or controlling block*** of the stock, so their disapproval of bringing the suit would not be disinterested; and

   c. **Non-ratifiable:** The wrong is said (by the court) to be ***"non-ratifiable."*** Typically, this will be the case where the wrong is an ***illegal act***, or amounts to a ***fraud*** on the shareholders. Cases alleging ***self-dealing*** are often held to fall into this "non-ratifiable" category. The theory behind this exception is that fraud or illegality injures the objecting shareholders so deeply that it is simply not in the majority's power to approve (by rejecting the suit) the imposition of such an injury on the minority. See the discussion of non-ratifiable self-dealing

supra, p. 207.

IV. DEMAND ON THE BOARD; EARLY TERMINATION BASED ON BOARD OR COMMITTEE RECOMMENDATION

A. Problem generally: Recall that a derivative action is brought "on behalf of" the corporation. Yet decisions about how the corporation's affairs should be run are ordinarily reserved to the board of directors (see *supra*, p. 50). If a plaintiff may litigate a derivative suit on the corporation's behalf even though the board opposes the action, the board's customary power to make major business decisions concerning the corporation's operations is effectively curtailed. Furthermore, the plaintiff or the plaintiff's lawyer will often have an incentive to bring frivolous claims for their "nuisance" or settlement value, and the corporation itself may suffer if the time of the board and senior executives is used up in dealing with a protracted meritless suit. These considerations support giving the board, or perhaps a special committee of the board, at least some power to review the action, to determine whether it is in the corporation's best interest, and if not, to have it dismissed.

1. **Insiders as defendants:** On the other hand, many serious derivative suits allege wrongdoing by corporate insiders, including (1) board members and/or (2) the senior executives who were responsible for the board members' getting their board seats in the first place. If left to its own devices, the board will rarely institute action against a corporate insider. Thus in precisely the situations where derivative actions serve their most worthy purpose, giving the board a substantial say in whether the action should proceed will undermine the very purpose of allowing derivative actions in the first place.

2. **Dilemma:** Courts have, therefore, struggled to find rules that will on the one hand maintain the board's ability to control the corporation's affairs and to terminate frivolous actions at an early stage, yet will on the other hand prevent the board from

covering up for wrongdoing by its own members or other insiders.

a. **Protect board's autonomy:** In general, courts and statutes have tried to protect the board's autonomy by (1) requiring a demand to be made on the board in most instances; (2) giving substantial weight to the board's decision not to pursue the action; and (3) increasingly, by giving significant weight to the recommendation of a specially-appointed board committee, made after investigation, that the suit be dismissed.

b. **Block coverups:** At the same time, courts and statutes have tried to block coverups by: (1) excusing demand on the corporation in many instances, in which case the suit is typically allowed to go forward even though the board would or does oppose the suit; and (2) ignoring the board or special committee's opposition to the suit where the essence of the complaint is that the board, or persons who dominate the board, have received an improper personal financial benefit by the act complained of.

c. **Three topics:** Therefore, we can break down the topic of "early termination based on board or committee action" into three separate topics:

(1) When is demand on the board ***excused***, and what are the consequences of such an excuse?

(2) If demand is ***not*** excused, and the board ***rejects*** the demand, when should the court nonetheless ***allow the action to go forward***? and

(3) If demand is made, the board appoints a special ***independent committee*** to review the merits of the action, and the committee recommends dismissal, how much weight should the court give that recommendation?

We consider each of these questions in turn.

B. Demand excused: First, when is a demand on the board ***excused***, and what are the consequences of excuse? Let's consider these questions in reverse order:

1. **Consequences of excuse:** If demand on the board is excused, the action normally may ***proceed*** without any early judicial overview of its merits (except, perhaps, for a motion for summary judgment by the corporation or the defendants). However, even in cases where demand is excused, the board may appoint an independent committee to review the suit; if that committee investigates and recommends dismissal, the court usually may consider whether to accept that recommendation and dismiss the suit, just as if demand had been made and the committee appointed. (The whole issue of an independent committee's recommendation is discussed *infra*, p. 329.) But in general, the plaintiff will have a much ***easier time having his action go forward*** without close judicial scrutiny of the merits if the case falls in the "demand excused" category than if it falls within the "demand required" category. For this reason, the issue of whether the case is a "demand excused" or "demand required" one is typically subjected to bitter and protracted litigation.

2. **When is demand excused:** In the broadest sense, demand on the board is excused where it would be ***"futile."*** Typically, demand will be deemed excused if the board is accused of having participated in the wrongdoing — in this situation, the board is unlikely to, in effect, recommend suit against its own members collectively. On the other hand, courts vary with respect to what kind of board conduct the plaintiff must allege in order to escape the demand requirement.

   a. **Board wrongdoing alleged:** Most cases in which P argues that demand should be excused are ones in which the ***board itself*** is charged with some sort of ***wrongdoing*** (either breach of the duty of due care or breach of the duty of loyalty), and the issue is what kind of board wrongdoing will be sufficiently grave that a subsequent demand by P to the board should be deemed "futile" and thus excused.

3. **Delaware view:** In Delaware, a plaintiff who attacks a board decision as wrongful must nonetheless make a demand on the board, unless he carries the burden of showing a ***reasonable doubt*** about whether the board either: (1) was ***disinterested*** and

independent; or (2) was entitled to the protections of the ***business judgment*** rule (see *supra*, p. 132).

Example of category (1): P might bring the case into category (1) — board not disiniterested and independent — by showing, for instance, that each member of the board was ***hand-picked*** by D (the president and controlling shareholder), and that when the board members approved, say, a very generous salary for D, they were motivated principally by a desire to ***ensure their continued re-election*** to the board.

Example of category (2): P might bring the case within category (2) — that the decision was not entitled to protection of the business judgment rule — by showing either that the board members did not follow ***adequate procedures*** in reaching their decision (e.g., they did not conduct a reasonable inquiry; see *Smith v. Van Gorkom*, *supra*, p. 186) or that the board's decision was, substantively, so ***irrational*** as to be outside the bounds of reasonable business judgment. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

a. Difficult to do: But Delaware makes it very ***difficult*** for the plaintiff to succeed in bringing the case within either category (1) or (2), and thus difficult to get demand excused. Here are some of the ways that Delaware courts do this:

i. Specificity: Although P must merely ***plead*** (not submit evidence of) facts sufficient to get the case within (1) or (2), the facts must be plead with great ***specificity***. For instance, in *Aronson*, *supra*, P alleged that D, a 47% shareholder in the corporation, had personally hand-picked each of the directors, who had then approved a very generous retirement/consulting package for D. The court held that these allegations were not specific enough to show the board's lack of independence; instead, P had to come up with an even more particularized showing of how the board was under D's dominance at the time it approved his contract.

ii. Liability of board: Similarly, the fact that the board itself

is being charged with a violation of the duty of due care for having approved the transaction is ***not enough*** to render demand futile and thus excused.

iii. Discovery: The plaintiff will not normally be able to obtain ***discovery*** in order to be able to make the particularized allegations that are required. S,S,&B, p. 1078.

iv. Self-dealing transaction: Finally, even though the suit alleges gross self-dealing, usurpation of corporate opportunity or other breach of loyalty by an insider, and even though this self-dealing was ***approved*** in advance or after-the-fact by the board of directors, demand will still not be excused unless there is a particularized showing that the board was not independent or acted irrationally. *Id.*

v. Summary: In summary, it will be a relatively rare Delaware case in which the plaintiff is able to allege board misconduct with enough specificity to get the demand excused.

4. New York law: New York seems to follow roughly the same approach as Delaware in distinguishing between situations in which demand is excused on account of futility and those in which demand is required. In *Marx v. Akers*, 666 N.E.2d 1034 (N.Y. 1996), New York's highest court gave a succinct summary of when demand will be excused. Demand will be ***excused*** if (and only if) the complaint alleges "with particularity" any of the following:

[1] "that a ***majority of the board*** is ***interested*** in the challenged transaction." (A director can be "interested" either because she has a direct self-interest in the transaction, or because, although she has no direct self-interest in the transaction, she has lost her independence by being "controlled" by a self-interested director.)

[2] that the board "***did not fully inform themselves*** about the challenged transaction to the extent reasonably appropriate under the circumstances." In other words, a director who

merely "passively ***rubber-stamp[s]*** the decisions of the active managers" does ***not*** thereby exempt herself from liability.

[3] that "the challenged transaction was so ***egregious on its face*** that it ***could not have been the product of sound business judgment*** of the directors."

C. Demand refused: Suppose now that the case falls within the ***"demand required"*** rather than "demand excused" category. If the plaintiff makes his demand on the board, and the board ***rejects*** the demand and refuses to sue (as it almost always does), may the plaintiff continue with his suit?

1. Suit against unaffiliated third party: Where the suit is against a ***third party*** who is not a corporate insider, the plaintiff will almost never be permitted to continue his suit. In this situation, the board's rejection of demand constitutes a decision about how the corporation should ***conduct its ordinary business affairs.*** Therefore, the court will almost always give the directors' decision not to pursue the suit the protection of the ***business judgment rule***. (Remember that under this rule, *supra*, p. 182, the board's decision on a business matter will be respected by the court so long as it is made in good faith, with reasonable procedural safeguards, and is not totally irrational, even though the court may believe that the decision was substantively unwise.)

2. Suit against insider: Where (as is usually the case) the suit is against a corporate ***insider***, the situation is more complex. But here, too, the court will give the board's decision not to sue the protection of the business judgment rule, unless P alleges that the board: (1) somehow ***participated*** in the alleged wrong (e.g., they got some ***personal benefit*** from it); or (2) the directors who voted to reject the suit were ***dominated or controlled*** by the primary wrongdoer. Clark, p. 644. If P can show either of these two things, then the court will generally remove the cloak of the "business judgment rule" from the board's decision not to sue, and will allow P's suit to go forward.

a. Similarity to demand-excused rules: You will notice that

these two situations (selfdealing and domination) that will allow P to sue notwithstanding the refusal of his demand are very similar to the factors that will cause the demand to be ***excused*** in the first place (see *supra*, p. 326). If this is so, the court's decision to put the case into the "demand excused" rather than "demand required" category doesn't make as much difference as is usually thought — the same factors of self-interest or domination will allow the plaintiff to proceed regardless of which category the case is placed in. But it is probably the case that, in most jurisdictions, it is somewhat easier to convince the court that demand would be futile (and thus should be excused) than to convince the court that the board's rejection of a required demand was so wrongful that it should not be protected by the business judgment rule.

i. Require demand in all cases: Because of the similarity between the factors required for excusing demand and those required for letting the plaintiff proceed despite the board's rejection of the demand, some commentators have argued that demand should be required in ***all*** cases, and that the board's self-interest or domination by wrongdoers should ***only*** be litigated after the board has rejected the demand.

(1) MBCA: The MBCA agrees: demand on the board is ***required in all cases***. See MBCA §7.42(1).

(2) ALI: Similarly, the ALI's *Principles of Corporate Governance* require demand in all instances. See *infra*, p. 336.

ii. Contrary view: But others argue that requiring a demand in all cases, even where it would clearly be futile, creates delay and expense — "[w]hen directors receive a demand they inevitably embark on a flurry of defensive maneuvers at corporate expense, and the plaintiff's law suit is at least delayed until a reasonable time for their response has passed." Clark, p. 645. This delay and expense is a reason, though not a terribly powerful one, for not requiring a demand that is clearly futile.

D. Use of independent committee: The most important development in derivative litigation over the last few decades has been the wide-spread use by corporations of ***independent committees*** to defeat derivative litigation.

1. **How the committee works:** Here is how this process works: As soon as P files his derivative suit or makes a demand on the board, the board appoints a supposedly "independent committee" of directors to investigate P's allegations.

   a. **No financial stake:** To ensure that the committee is "independent," only those directors who have ***no financial stake*** in the transaction that P is complaining about are put on the committee. If all directors are being sued, the board may even vote to enlarge itself by the appointment of one or more additional new directors, who are then immediately appointed as the committee.

   b. **Investigation and report:** The committee typically procures independent counsel, and then goes on to make an extensive investigation, usually including extensive interviewing of witnesses, and culminating in an extensive written report.

   c. **Dismissal recommended:** In virtually all instances, the committee recommends that P's suit be ***dismissed***. Sometimes, this recommendation is based on a finding that P's allegations simply have no substantive merit. Often, however, the committee reasons that although the allegations have merit, the burden to the corporation of pursuing the suit would outweigh any possible recovery.

2. **Business judgment rule:** Why does the corporation go through all this? Principally because of the hope that when the committee recommends dismissal of the action, and the board then seeks judicial dismissal based on the recommendation, the court will afford the recommendation and board decision the protection of the ***business judgment rule***. The court will not in fact always do so; indeed, when the court should and should not give the committee report business-judgment-rule protection is the main issue in connection with independent committees. But courts

grant this protection often enough that corporations and their boards typically find it well worthwhile to undergo the considerable expense of setting up such a committee.

3. **Judicial review:** Courts do not simply rubber stamp an independent committee's decision not to pursue the suit. For instance, if P can show that the committee was not really independent, or did not conduct even a reasonably careful investigation, the court is unlikely to dismiss P's suit based on the committee recommendation. But the much more interesting question is whether, if the court is convinced that the committee was independent and used appropriate procedures, the court may nonetheless use its ***independent judgment*** about whether P's suit has merit. On this issue, courts vary widely. There seem to be two main positions, the New York position and the Delaware position.

   a. **New York:** The New York approach makes it very difficult for the plaintiff to overcome the independent committee's recommendation that the suit be terminated. The plaintiff is entitled to show that the members of the committee were not in fact independent (e.g., that they were dominated by the controlling shareholder who was accused of wrongdoing), or that the committee did not use reasonable procedures in reaching its conclusion (e.g., its investigation was very shallow). But once the court is satisfied with the committee's independence and procedures, the New York courts will ***not review the merits of the substantive recommendation that the suit be dismissed***.

      i. **Business judgment rule:** In other words, the court will not attempt to make an independent determination of whether the committee was correct in its conclusion that the probability of recovery was low, the costs of proceeding with the suit would be high, etc. Instead, the committee's substantive recommendation that the suit be dismissed, and the board's approval of that recommendation, ***receive the protection of the business judgment doctrine.*** See *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979).

b. **Delaware view:** Delaware, by contrast, will in some situations let its courts ***review the substantive merits*** of the committee's recommendation that the suit be dismissed. The Delaware approach was articulated in the landmark case of ***Zapata Corp. v. Maldonado***, 430 A.2d 779 (Del. 1981), a case in which the Delaware Supreme Court tried hard to reconcile the need for early termination of meritless actions with the need to make sure that the independent committee does not simply rubber-stamp wrongdoing by insiders.

i. **Two-step test:** Under *Zapata*, the Delaware courts will use a ***two-step*** test to determine whether the committee's recommendation of dismissal should be followed:

(1) Step 1: The court will determine whether the committee acted ***independently*** and in ***good faith***, and whether the committee used ***reasonable procedures*** in conducting its investigation. If the answer to any of these questions is "no," then the court will ***automatically disregard the committee's dismissal recommendatio***n, and will ***allow the suit to proceed***. For instance, if the committee members are shown to have been dominated by a controlling shareholder, or to have been motivated by their own self-interest (e.g., they are themselves accused of wrongdoing by the plaintiff), or if they conducted a shallow investigation, the committee recommendation will be disregarded.

(2) Step 2: Even if the committee passes all the procedural hurdles of step one, a court may go onto a second step: here, the court may determine, by ***"applying its own independent business judgment,"*** whether the suit should be dismissed. It is in this second step that the Delaware approach varies sharply from the New York approach: whereas the New York courts would never enter this second step at all (and would always dismiss the suit if the committee passed muster under Step 1), the Delaware courts retain the freedom to allow the suit to continue even though the committee acted with

procedural correctness. In other words, in Delaware the committee's recommendation that the suit be dismissed will ***not be given the protection of the business judgment doctrine***. For instance, if the court feels that the suit has merit, and would probably result in a substantial recovery for the corporation, the court may allow the suit to go forward even though the committee (acting with procedural correctness, independence, and good faith) has recommended against continuation of the action.

ii. Only in "demand excused" cases: Apparently, it is only in cases falling into the "demand excused" rather than "demand required" variety that the court will use the two-step test of *Zapata*. If demand is ***required***, and the corporation responds by appointing an independent committee that then recommends not continuing the suit, the court will apparently treat the case just as it would treat a case in which the main board rejects the plaintiff's demand. In that situation, only the independence, procedural correctness, and good faith of the committee, ***not the substantive merit of its decision,*** will be reviewed by the court. See *supra*, p. 326.

4. The "structural bias" problem: The principal criticism that is usually lodged against the use of a committee of "independent" directors is that such directors are ***not really "independent,"*** in a ***psychological*** sense.

a. Rationale: There are two main reasons for this critique of independent-director committees:

(1) The "independent" directors are nonetheless directors. They sit on the same board with the non-independent directors (i.e., directors who have a clear interest in the outcome, and who are often themselves defendants in the action). The independent directors know that they may continue to sit on the board after the committee's investigation is completed, and that they will therefore

have to ***get along with the interested directors.*** To the extent that the independent disinterested directors value the compensation, prestige or other aspects of directorship, they are likely to have at least an unconscious bias in favor of the defendants.

(2) The committee is typically appointed by a vote of the entire board, including the interested directors. Unless the interested directors are stupid, or lacking in insight, they will not appoint committee members who are known for their independent way of thinking or for sympathy to derivative plaintiffs.

See S,S,B&W, pp. 1105-07.

b. MBCA: Concerns about "structural bias" led the drafters of the 1989 revision to the MBCA to require that the independent committee be elected by majority vote of the independent directors. See MBCA §7.44(b)(2).

c. Tough standard for independence in Delaware (*Oracle* case): Concern about whether the members of independent committees are really psychologically independent has led the Delaware courts to impose a ***heavy burden*** on the committee to demonstrate its members' independence. As the Delaware Supreme Court has put it, the committee "has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife' — ***'above reproach.'"*** *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040 (Del. 2004).

Furthermore, as the result of ***In Re Oracle Corp. Derivative Litigation***, 824 A.2d 917 (Del. Ch. 2003), the Delaware courts ***consider social ties*** — not just direct financial ties — in deciding whether the directors are really independent of the persons whose conduct they are investigating. And those courts will be relatively quick to conclude that the directors' social ties make them *not* sufficiently independent, in which case the committee's decision not to pursue the suit will not be accorded judicial deference.

i. **Facts:** In *Oracle*, plaintiff shareholders brought a derivative suit alleging insider trading by four Oracle directors, including CEO (and multibillionaire) Larry Ellison and non-executive directors Lucas and Boskin (we'll call all three the "Trading Defendants"). In response, Oracle formed a special litigation committee (SLC) of board members to evaluate the merits of the suit. The SLC consisted solely of two Stanford professors, Garcia-Molina and Grundfest, each of whom had also gotten graduate degrees from Stanford.

   (1) **SLC Report:** The SLC investigated the insider-trading allegations extensively, and issued a report of that investigation. The report concluded that there was not credible evidence of insider trading, and that the suit should not be pursued. The report also concluded that the two SLC members, although they had minors ties to the trading defendants, were sufficiently independent of those defendants and of Oracle.

   (2) **Dismissal sought:** Oracle then tried to have the suit dismissed, over the plaintiffs' objection. Oracle claimed (as is standard in cases where the SLC finds the suit without merit) that the committee's decision to discontinue the suit should be binding on the court.

ii. **Ps claim the SLC was not disinterested:** But the plaintiffs claimed that the two members of the SLC had not in fact been disinterested, because of their extensive social and business ties to the three Trading Defendants. Therefore, the plaintiffs said, the SLC report's conclusion that the suit should be dismissed as meritless was not entitled to judicial deference.

iii. **Court agrees:** The Delaware Chancery Court agreed with the plaintiffs, concluding that ***the SLC had not carried its burden of demonstrating that the two SLC members were sufficiently independent*** of Oracle and of the Trading Defendants. The court's decision focused on ***social*** rather

than economic ties between the SLC members and the Trading Defendants. The ties that the court relied on arose out of the fact that the SLC members and the trading defendants all had extensive connections to Stanford University. And, while the SLC report itself disclosed some of these ties, the court gave great weight to additional Stanford-related ties that the report had not disclosed.

(1) **Boskin:** For example, Boskin (one of the Trading Defendants) had taught Grundfest (one of the two SLC members) at Stanford in the 1970s when Grundfest was a PhD candidate. Furthermore, the two were, at the relevant times, both members of the steering committee at a Stanford entity, the Stanford Institute for Economic Policy Research.

(2) **Lucas:** Similarly, there were Stanford ties between both SLC members (remember, they were both sitting Stanford professors) and another trading defendant, Lucas. Not only was Lucas a Stanford alumnus, but a Lucas family foundation, of which Lucas was chairman, had given almost $12 million to Stanford. And Lucas himself had given $4 million to the school.

(3) **Ellison:** Finally, Ellison, the Oracle CEO, was an ongoing benefactor to Stanford. A medical foundation he started had given or pledged nearly $10 million to Stanford. And at the time the SLC committee was formed, Ellison was discussing with Stanford funding a $170 million Ellison Scholars Program modeled on the Rhodes scholarship.

iv. "Domination and control" argument: Oracle argued that none of these Stanford-related ties should make any difference on the issue of independence. Oracle contended that the test for independence of the SLC members should be whether they were under the ***"domination and control"*** of the interested parties (i.e., the three Trading Defendants). Since the Trading Defendants did not have the practical

ability to deprive either SLC member of his tenured Stanford position (and Stanford itself did not have any practical way to punish either of them if the university was displeased with any action the SLC member took against the Trading Defendants), Oracle argued, the SLC members were not under the Trading Defendants' domination and control, and were thus automatically independent.

(1) Argument rejected: But the court flatly ***rejected*** this argument by Oracle: "[A]n emphasis on 'domination and control' would serve only to fetishize much-parroted language, at the cost of denuding the independent inquiry of its intellectual integrity." The independent inquiry ***should not "ignore the social nature of humans[.]"*** Corporate directors are "generally the sort of people deeply enmeshed in social institutions," and such directors ***should not be assumed to be "persons of unusual social bravery***, who operate heedless to the inhibitions that social norms generate for ordinary folk." The social ties among the SLC members, the Trading Defendants and Stanford were "so substantial that they ***cause reasonable doubt about the SLC's ability to impartially consider*** whether the trading defendants should face suit."

(2) Boskin: For instance, as to the insider-trading claim against Boskin that the SLC was evaluating, the SLC members could not be counted on to be impartial for several reasons. First, Boskin was the committee members' fellow Oracle board member. Second, Boskin was a fellow member of the faculty at the university (Stanford) where both SLC members taught, and "To accuse a fellow professor — whom one might see at the faculty club … — of insider trading cannot be a small thing — even for the most callous of academics." Finally, Boskin had taught one of the SLC members (Grundfest), and the two had maintained contact over the years, making it even harder for Grundfest to be

objective about whether to recommend suit against Boskin. (There were similar ties between the SLC members and the two other Trading Defendants.)

(3) Conclusion: In summary, the various connections between the SLC members and the trading defendants were sufficiently extensive that these connections would ***"weigh on the mind*** of a reasonable [SLC] member in deciding whether to level the serious charge of insider trading against the Trading Defendants." (It didn't matter whether this "weighing on the mind" would make the SLC member *more* favorable or *less* favorable to the defendant — a risk that the SLC member would "lean over backward" not to favor the defendant would be just as bad from an independence standpoint.) Therefore, the court said, the SLC was not independent, and its conclusion should be disregarded by the court; the suit should proceed rather than being terminated as the SLC recommended.

v. Significance of *Oracle*: The significance of the *Oracle* case is that when a Delaware court is deciding whether a supposedly independent committee was sufficiently independent to entitle the committee's dismissal recommendation to judicial deference, independence should be evaluated by a ***broad, holistic method.*** The issue is ***not*** merely whether the committee members are under the ***domination and control*** of the interested parties, or whether the interested parties, if unhappy with the committee's decision, could inflict economic damage on the committee members. Instead, the whole range of "soft" non-economic ***social ties*** between the committee members and the interested parties must be considered. So, for example, the fact that a committee member and a defendant sit on the company's board together, or are graduates of the same schools, or work for the same large institution, or are even social acquaintances — any of these would be a factor (though not necessarily a dispositive one) pushing the court

towards a conclusion that the committee is not truly independent.

(1) Non-Delaware courts: *Oracle* has been very influential — a number of courts outside Delaware have followed *Oracle's* approach of considering social, not just economic, ties between the committee members and the interested parties in determining independence. See Hamilton (10th Ed.), p. 740.

d. Court-appointed committee: Perhaps the best solution to the whole problem of finding a way to gain early dismissal of meritless derivative suits is to have the ***court***, not the directors, appoint an independent committee. Where the committee is appointed by the court, it need not consist of directors; the odds are therefore much better that such a panel will be truly independent of the defendants. Thus MBCA §7.44(f) allows the court to appoint an independent panel, whose results will be in practice (though not as a strict matter of law) binding on the court.

E. The MBCA approach: The ***MBCA's*** procedures on derivative suits are covered in Subchapter D of Chapter 7, in §§7.40-7.47. The heart of Subchapter D is §7.44, which spells out in unusually great detail when the court may dismiss the derivative proceeding at the corporation's request. The essence of §7.44 is that the court ***must dismiss*** so long as the board vote to dismiss is made ***after reasonable inquiry*** and ***in good faith*** — the court may not insist that the action be continued merely because the court thinks that, objectively, the action has merit and would benefit the corporation.

1. No distinction between demand required and demand excused: Because the MBCA requires a written demand on the corporation in ***all*** situations (see §7.42, discussed *supra*, p. 324), there is no distinction between the "demand excused" and the "demand required" situations, as there is in Delaware.

2. Vote of independent directors: When the directors vote to recommend discontinuance of the derivative action, the only votes that count are the votes of ***"independent directors."*** If

independent directors constitute a quorum of the board, then all that is required is that a ***majority of these independent directors*** must vote to discontinue the action. (In other words, the entire board can vote, as long as a quorum of independent directors are present, and as long as a majority of the independent directors vote to recommend discontinuance.)

a. **Committee:** Alternatively, a ***committee*** consisting of two or more independent directors may vote on discontinuance. This "committee" method is available in all circumstances, and is the required method where a majority of the full board is not independent. The committee must be selected by majority vote of the ***independent directors***. §7.44(b)(2). This method of allowing only independent directors to select the independent committee members is designed to counter the problem of "structural bias," discussed *supra*, p. 331.

3. **Standard by which board or committee is to act:** What are the standards by which the board or the committee is to reach its decision? Under §7.44(a), the majority of independent directors (or the majority of a committee of independent directors) must "determine[] … in ***good faith*** after conducting a ***reasonable inquiry*** upon which its ***conclusions are based*** that the maintenance of the derivative proceeding is not in the ***best interests*** of the corporation."

4. **Meaning of "independent" directors:** Subchapter D does not define an ***"independent"*** director. However, §7.44(c) specifies several things that will ***not*** prevent a director from being deemed independent, including: (1) that she was ***nominated*** or ***elected*** to the post of director by ***vote of a defendant*** in the derivative proceedings; (2) that she is ***herself a defendant*** in the derivative proceeding; or (3) that she ***voted to approve the act*** being challenged (so long as the act resulted in no personal benefit to herself.) On the other hand, any showing that the director ***benefited*** from the challenged action, or that the director is ***beholden*** for her livelihood to a person who is charged with receiving a personal benefit from the challenged transaction, probably would be enough to lead a court to find that the director

was not “independent.”

5. **Significance:** The MBCA seems to make it relatively ***easy*** for the corporation to ***obtain a dismissal*** of the derivative action. If the board has a majority of “independent” directors (as the boards of most publicly-held corporations probably do today), the plaintiff will bear the burden of showing that the independent directors did not act in good faith, or did not conduct a reasonable inquiry. Even where a majority of the board is not independent, the fact that the corporation merely has to show good faith and reasonable inquiry, rather than the objective reasonableness of its action, will mean that the court will have no choice but to dismiss the action most of the time.

V. SECURITY-FOR-EXPENSES STATUTES

A. **Generally:** About 14 states have so-called ***“security-for-expenses”*** statutes. These statutes require certain plaintiffs to post a ***bond*** to guarantee that if the corporation incurs expenses in connection with the derivative suit, the court can order those expenses reimbursed to the corporation by means of the bond.

1. **Rationale:** These security-for-expenses statutes reflect a basic hostility toward shareholder derivative actions, especially towards the possibility that a plaintiff’s attorney might bring a frivolous action for the sole purpose of extracting a “nuisance value” settlement. The idea is that if the plaintiff is required to post a bond to cover the corporation’s out-of-pocket expenses, P and his attorney will be less likely to bring such “strike suits.”

2. **Criticisms:** On the other hand, critics of security-for-expenses statutes point out that such statutes are ***overinclusive***: they are almost as likely to screen out meritorious suits as meritless ones, since the bond required may be much greater than the amount by which a plaintiff would benefit even if the suit were found to have merit. Also, since most such statutes apply only in the case of small shareholders (see *infra*), they are criticized on the grounds that they discriminate against small holders and in favor of large ones.

3. **Small shareholders:** Most security-for-expenses statutes apply only to suits brought by ***"small"*** shareholders (i.e., those whose stake in the corporation is less than a certain size). For instance, New York's statute (B.C.L. §627) requires the bond to be posted unless the plaintiff holds either: (1) 5% or more of some class of the corporation's shares; or (2) shares having a market value of more than $50,000.

4. **What are "expenses":** For most of these statutes, "expenses" covers much more than court costs. Typically, the court may order security posted to cover the corporation's anticipated ***legal fees*** in connection with the action. S,S,B&W, p. 1113-14. Even more important, "expenses" usually includes ***indemnification*** payments made by the corporation to the defendants (e.g., directors), which may be made by the corporation under a variety of circumstances (see *infra*, p. 341). The net result is that the court may order the plaintiff to post a bond in a sum that is likely to be out of all proportion to what the plaintiff or the plaintiff's lawyer can expect to recover if victorious.

B. **Not substantial impediment:** Therefore, you would expect that such statutes would be a serious impediment to the bringing of derivative suits. But the reality is that such statutes do ***not*** seem to have had that effect.

C. **Many states do without:** In any event, many jurisdictions have no security-for-expenses statute, and yet do not seem besieged by meritless derivative actions. For instance, neither Delaware nor the MBCA has such a provision.

1. **Limited:** A few other jurisdictions have security-for-expenses statutes that operate not on the basis of size of plaintiff's stake, but rather only where a court determines that the action is probably ***frivolous.*** For instance, under the California statute (Cal. Corp. Code §800(c)-(f)), the corporation may only obtain a bond if it convinces the court that there is ***"no reasonable possibility"*** that the action will benefit the corporation or its shareholders.

D. **Recovery against bond:** Suppose that the plaintiff does post the

bond, tries the suit, and loses. Generally, the corporation is ***not*** entitled to ***automatically*** recoup its expenses against the bond. Instead, it is usually up to the court to decide how much the corporation should get from the bond. For instance, under New York's B.C.L. §627, the corporation may have recourse to the bond "in such amount as the court having jurisdiction of such action shall determine upon the termination of such action."

1. **No personal liability:** Also, the plaintiff is generally ***not personally liable*** for the corporation's expenses. In other words, he is not liable beyond the amount of the bond. C&E, pp. 1091-92.

VI. SETTLEMENT OF DERIVATIVE SUITS

A. Danger of collusion: Derivative litigation is essentially a three-party game. The three parties are: (1) the plaintiff shareholder (and his lawyer); (2) the corporation; and (3) the individual defendants charged with wrongdoing. Typically, parties (1) and (3) will be the most actively interested in the litigation, since they are the real protagonists; the corporation usually does little more than stand by and watch (with the board, assuming it is not charged with wrongdoing, not helping either party but probably rooting for the defendants for the reasons described *supra*, p. 278). If the plaintiff and the defendants could settle the litigation on their own, they would have a strong incentive to benefit themselves at the expense of the corporation and its non-party shareholders. For instance, they might agree to a token recovery on behalf of the corporation, accompanied by a substantial payment to the plaintiff's attorney as his "fee."

1. **Plaintiff doesn't object:** The plaintiff probably won't object to such a settlement, since the plaintiff is usually a nominal figure who has very little direct interest in the outcome (he benefits only to the extent that the value of his stockholdings increases).

2. **Corporation doesn't object:** Nor will the corporation typically object, since it (or at least its board of directors) is typically hostile to the action in the first place.

3. **Danger:** Yet the net result of such a settlement may be that a serious wrong to the corporation and its shareholders goes uncorrected, whereas a full trial of the action might have produced a substantial recovery for the corporation. In summary, there is a major risk of ***collusive settlements*** in derivative actions.

B. **Judicial approval:** Because of this danger of collusion, most states require that any settlement be ***approved by the court***. Clark, p. 657. Only if the proponents of the settlement (generally the plaintiff's attorney and the defendants) convince the court that the settlement is in the best interests of the ***corporation*** and its shareholders, will the court approve the settlement.

C. **Notice to shareholders and opportunity to intervene:** In the federal courts, and in many state courts, shareholders must be given ***notice*** of the proposed settlement, and the opportunity to intervene in the action to oppose the settlement. Statutes vary widely as to when notice is required, and what type of notice.

1. **Federal suits:** In ***federal*** suits, Fed. R. Civ. Proc. 23.1 is somewhat vague: "[N]otice of the proposed dismissal or compromise shall be given to shareholders … ***in such manner as the court directs."*** Usually, federal courts will order notice by ***mail*** to each shareholder of record. However, where such notice would be very costly, the court will sometimes use its discretion to allow for notice by ***publication***, or by a mailing to just a ***random sample*** of shareholders. *Id.* It is probably up to the discretion of the court which party shall bear the cost of notice.

2. **Intervention:** The main purpose of notice to other shareholders is that any shareholder may then ***intervene***, and argue at the court's hearing on the proposed settlement that the settlement should not be approved. The intervening shareholder might argue, for example, that the proposed settlement is a collusive one in which plaintiff's lawyer is maximizing his fees, defendants are paying relatively little to the corporation, and the corporation, after payment of the attorney's fees, will be left with far less than the true "value" of its cause of action. However, the

intervenor will generally be a complete outsider who will have little ability to make such a showing.

3. **Res judicata effect:** If notice of the proposed settlement is given to all shareholders, the settlement will generally be ***binding*** on them. For this reason, the corporation and the defendants will often want notice to be given to all shareholders even if it is not required by the statute.

D. **Factors to be considered by court:** In deciding whether to approve the settlement, the court typically considers a number of factors, including: (1) the best possible recovery that might occur at trial; (2) the likely (as opposed to highest possible) recovery at trial; (3) the probable expense to the corporation of litigating through trial; and (4) the defendants' ability to pay a judgment higher than the proposed settlement amount.

1. **Key factor:** Of these, the most important factor is usually the relation between the size of the ***net financial benefit to the corporation*** under the settlement versus the probable net financial benefit to the corporation if the case were to be tried.

a. **Subtract counsel fees and indemnification:** The court will often subtract anticipated ***counsel fees*** and ***indemnification payments*** that will be made by the corporation to the defendants (see *infra*, p. 341) in calculating the net benefit to the corporation, both under the settlement and as would be likely to occur at trial. Thus even where the defendants are paying the corporation a substantial sum, the court might not approve the settlement if it concludes that once the corporation pays the plaintiff's attorney's fees (and these fees are always paid by the corporation out of its recovery, see *infra*, p. 340), too little money will remain in the corporation's coffers.

2. **Non-pecuniary benefits:** Often, a proposed settlement will include ***non-pecuniary benefits*** to the corporation. For instance, the corporation may agree to add ***outside directors*** to its board, to beef up its internal financial controls so as to prevent similar wrongdoing in the future, to cancel stock options granted to the wrongdoers, or to take other action that does not put immediate

dollars in the corporation's coffers. A court approving a proposed settlement will sometimes attribute some value to such non-pecuniary benefits. But in general, courts are somewhat ***skeptical*** of such benefits, because they can "sometimes represent a means by which the parties can ***increase the apparent value*** of the settlement and thereby justify higher attorney's fees for plaintiff's counsel, who is often the real party in interest." ALI Prin. Corp. Gov., §7.14, Comment e.

3. **Strength of case:** Obviously, in reviewing the settlement the court will consider the probable ***strength of the plaintiff's case*** — the stronger the claim, the more favorable to the plaintiffs the settlement will have to be.

E. All relief must go to corporation: An additional way in which courts discourage collusive settlements is that all payments made in connection with a derivative action must be ***received by the corporation***, not by the plaintiff.

F. Other terminations: As noted, a settlement must, in most jurisdictions, be approved by the court. Jurisdictions following this rule usually extend it to apply to a ***voluntary dismissal*** or ***discontinuance*** as well. Thus once P brings a derivative action against D, he cannot simply abandon the action without judicial approval in most states — there is too much risk that P (or more probably his lawyer) is being in effect "paid off" to drop the action. See ALI Prin. Corp. Gov., §7.14(a). Similarly, if notice to shareholders would be required for a settlement, it is generally required for a voluntary dismissal. *Id.*

1. **Involuntary dismissal:** But where the court issues an ***involuntary dismissal*** of the action (e.g., it grants a summary judgment against P because of the legal inadequacy of the claim), no formal "judicial approval" or notice to shareholders is called for — there is little danger of collusion between plaintiff and defendant in this situation. ALI Prin. Corp. Gov., Comment c to §7.14.

G. Settlement between corporation and insider: So far, we have been assuming that the settlement is between the plaintiff

shareholder and the defendants. Suppose, however, that the ***corporation itself***, without the plaintiff shareholder's consent, tries to settle with the defendant on the underlying corporate claim against that defendant. May the corporation do this without judicial approval, and if it may, will this be binding on the plaintiff?

1. **Other jurisdictions:** Most states that require judicial approval of ordinary settlements in derivative actions seem to require such approval of settlements between the corporation and the defendants as well. See, e.g., ALI Prin. Corp. Gov., §7.15. In any event, because a settlement between the corporation and the defendant that did not include judicial approval or shareholder notice probably wouldn't be binding on shareholders anyway, the corporation and defendants are quite unlikely (and unwise) to settle without such approval even if they could.

VII. PLAINTIFF'S ATTORNEY'S FEES

A. The problem: Normally, U.S. courts follow the so-called "American" rule about attorney's fees: each side pays its own attorney's fees. But adherence to this general rule in derivative actions would make such actions nearly impossible: the individual shareholder plaintiff almost never receives a sufficiently large financial benefit even from a successful suit to pay a reasonable attorney's fee out of the proceeds.

> **Example:** Assume that P owns 10% of the shares of XYZ Corp. P brings a derivative action against D, an XYZ director, which results in XYZ's recovering $1 million from D. Assume (as is usually the case) that a reasonable attorney's fee for such an action would be around 20% of the recovery. Before payment of the fee, P has only benefited by $100,000 (since the value of his shares has been enhanced by his 10% holding times the $1 million received by the corporation). If P has to pay a $200,000 attorney's fee, he will have a net loss of $100,000 on the transaction.

1. **Benefit to non-plaintiffs:** At the same time, the shareholders who did ***not*** join in the action would benefit from a "windfall"

— their shares would increase in value because of the recovery just as P’s have, yet they would not have to pay any part of the attorney’s fee. This problem is an aspect of the ***“free rider”*** problem, in which one party pays to bring about an event that benefits others who do not have to pay for it.

B. The “common fund” theory: To deal with this free rider problem, courts have adopted the so-called ***“common fund”*** theory. Under this theory, when a person’s efforts result in the establishment of a fund that benefits others as well as himself, that person’s attorney’s fees and expenses may be taken out of the fund. In the derivative context, the common fund doctrine allows plaintiff’s counsel to be ***paid out of the fund***, i.e., out of the recovery received by the corporation. All jurisdictions award the successful plaintiff attorney’s fees on this basis.

C. Amount of the fee: On the other hand, courts are in disagreement about how the amount of the fee should be ***calculated***. There seem to be two main approaches:

1. **The “lodestar” method:** Under the ***“lodestar”*** method, the key component is the ***reasonable value of the time*** expended by plaintiff’s attorney. This is computed by taking the actual number of hours expended by the attorney on the case, and multiplying it by a ***reasonable hourly fee*** for the type of work in question. After this number (the lodestar) is computed, the court can then ***adjust it up or down*** to reflect other factors. For instance, the court will often adjust it upwards to reflect the fact that there was a substantial ***contingency*** aspect to the case (i.e., P was by no means certain to prevail, so when he does prevail, the lawyer should get more per hour than where the lawyer was certain to be paid for each hour, as in the usual hourly fee arrangement).

2. **The “salvage value” approach:** The other common approach to fee calculation is the ***“salvage value”*** approach. Under this approach, the court calculates counsel fees by awarding a percentage of the total recovery. Typically, if the recovery is below $1 million, the award is in the 20-30% range, and if the

recovery is more than $1 million, the award is between 15 and 20%. See ALI Prin. Corp. Gov., §7.17, Comment c.

VIII. WHO GETS TO RECOVER

A. Pro rata recovery by individuals: The recovery in a derivative action must normally go ***to the corporation***, as we have seen (see *supra*, p. 339). Although individual shareholders are plaintiffs, the action they are asserting is one that is really "owned" by the corporation, and it is appropriate that the corporation, not the individual plaintiffs, should receive the recovery. But occasionally, it may be unjust or counterproductive to allow the corporation to recover. If so, the court may order that all or part of the recovery be distributed to ***individual shareholders*** on a ***pro rata basis*** (i.e., proportionally to their shareholdings).

1. Situations where pro rata treatment appropriate: Here are two common situations in which the court may well decide to award a pro rata rather than corporate recovery:

a. Wrongdoers in control: If the alleged wrongdoers remain in substantial ***control*** of the corporation, the court might decide to award pro rata recovery to the non-controlling, innocent, shareholders. The court is especially likely to do this where there is a danger that any recovery paid to the corporation will simply be diverted again by these same wrongdoers.

i. Mere fact of continuing ownership: By contrast, the mere fact that the wrongdoers continue as shareholders will ***not*** by itself lead the court to declare a pro rata recovery. Indeed, it is the ***defendant*** who will often urge a pro rata recovery in this situation, as a way of limiting the damages he must pay, but the court will usually ***reject*** this request.

b. Aiders and abettors: The court may also award pro rata recovery when most of the shares are in the hands of people who in some sense ***aided and abetted*** the wrongdoing, even though they are not deeply culpable themselves.

Example: Recall the facts of *Perlman v. Feldmann*, *supra*, p.

238, in which Wilport Co. (a group of steel end-users) bought D's control block in Newport Steel Corp. at a premium in order to get steel supplies at a time of shortages. After the court decided that D could not keep this control premium, it decided that this premium should be paid by D to the plaintiffs (the minority shareholders), not to Newport. The court reasoned that a payment to Newport would unjustly enrich Wilport, who had aided and abetted D's original wrongdoing by agreeing to pay the control premium to D.

IX. INDEMNIFICATION AND D&O INSURANCE

A. Introduction: A director or officer who is charged with breach of the duty of due care, the duty of loyalty, or other wrongdoing, can face very substantial damages. For instance, the defendant directors in *Smith v. Van Gorkom*, *supra*, p. 186, ended up settling the case for $23 million, even though they were guilty of at most gross negligence, not intentional wrongdoing. Because of this possibility of liability out of all proportion to compensation, directors and officers (and the corporations that will need their services) have struggled to find protection. The two principal methods for reducing the burden on individuals are: (1) ***indemnification***, in which the corporation reimburses the director or officer for expenses and/or judgments he incurs relating to his actions on behalf of the corporation; and (2) so-called ***"D&O"*** (directors' and officers') ***liability insurance***, which can be paid either to the corporation (to make it whole for any indemnification payments it makes to the individual) or directly to the director/ officer.

1. Third-party vs. derivative actions: In considering whether the corporation may indemnify or insure the director/officer against liability, it is important to distinguish between: (1) third-party actions brought directly against the individual; and (2) derivative actions brought in the name of the corporation. Statutes and case law are less likely to permit indemnification of judgments or settlements in derivative actions, since that would in effect lead to ***circular recovery*** (the corporation recovers against the defendant, then pays the money right back out to him as

indemnification).

2. **Self-dealing:** Also, be careful to distinguish between claims that allege self-dealing or other ***disloyalty***, and those that do not: statutes and case law are much more likely to permit indemnification and insurance where the defendant is guilty of breach of the duty of due care (even if his breach amounts to recklessness or gross negligence) than where his wrong consists of improperly receiving a financial benefit at the corporation's expense.

3. **Mandatory vs. permissive:** Lastly, you should distinguish between ***mandatory*** and ***permissive*** indemnification: In most states there are a few situations in which a corporation ***must*** indemnify a director or officer, but a large range of circumstances in which the corporation ***may*** indemnify him.

B. Indemnification generally: All states have statutes dealing with when the corporation may (or must) ***indemnify*** a director or officer against losses he incurs by virtue of his corporate duties.

1. **Who is covered:** In general, these statutes apply to both directors and officers (i.e., high-level executives). Even where the statute does not cover ***lower-level employees***, a court would probably hold that the corporation may offer the same indemnification to such an employee.

C. Mandatory indemnification: In most states, there are just two situations in which the corporation may be ***required*** to indemnify an officer or director: (1) when the director/officer is completely ***successful*** in defending himself against the charges; and (2) when the corporation has previously ***bound itself*** by charter, by law or ***contract*** to indemnify.

1. **Requirement of "success":** If the director or officer has been completely ***successful*** in defending himself against the charges of wrongdoing, he is ***entitled*** to indemnification in nearly all states. In other words, if the corporation refuses to reimburse him voluntarily, the director/officer may get a court order requiring the corporation to pay. However, the statutes vary somewhat as

to what constitutes "success."

a. Success not on the merits: Most states provide mandatory indemnification so long as the defendant is successful, whether the success is "on the merits" ***or not***. See, e.g., Del. GCL §145(c), N.Y. BCL §722(a). Thus in most states, the director or officer who successfully raises a ***technical defense*** like the statute of limitations is entitled to indemnification — these states reason that the defendant should not have to go through an entire trial on the merits when he has a technical defense available, merely in order to assure himself reimbursement.

i. Settlement by corporation but not by officer: Suppose the suit ends with the officer paying nothing, but with the ***co-defendant corporation paying a significant amount.*** Here, the officer is likely to be found to have "succeeded" (and thus to be entitled to mandatory indemnification) despite the corporation's payment, as long as the officer did not intentionally *cause* the corporation to make the payment.

Example: P is a silver trader for Conticommodity ("Conti"), a corporation. He spends over $2 million in legal fees defending himself against civil lawsuits and an enforcement proceeding by the Commodity Futures Trading Commission (CFTC). The civil suits include Conti as a co-defendant. P eventually settles the CFTC suit by paying a $100,000 fine. The civil suits end when Conti, but not P, pays $35 million to the plaintiffs in those suits (which are then dismissed as to P as well as to Conti). P attempts to have Conti reimburse him for his $1 million in legal fees spent on defending the private suits. Conti argues that P has not "succeeded" in defending the private suits, but has merely been "bailed out" by Conti's payment of enough money to end the suits against both defendants.

Held, for P. The suit against P was dismissed "without his having paid a settlement," and "it is not [the court's] business to ask why this result was reached." The result

might be different if P had sought, or acceded to, Conti's payment of the settlement; but he didn't. "Delaware law cannot allow an indemnifying corporation to escape the mandatory indemnification [provision] by paying a sum in settlement on behalf of an unwilling indemnitee." *Waltuch v. Conticommodity Svcs., Inc.*, 88 F.3d 87 (2d Cir. 1996) (construing Delaware law in a diversity case.)

b. **Finding of non-liability:** Generally, the director or officer will qualify for mandatory indemnification only if he is ***completely exonerated*** of wrongdoing. If the court finds that he has committed wrongdoing, but doesn't impose financial penalties, most states probably would regard D as ***not*** having been "successful," and would therefore not grant him mandatory indemnification.

2. **Provision in charter, by law or contract:** If the corporation ***obligates itself***, by a provision in its articles of incorporation, bylaws, or in a special contract with the director, to provide indemnification in certain circumstances, the court will ***enforce*** such a provision. In a sense, this can be viewed as "mandatory" indemnification — even if the corporation changes its mind and refuses to pay, the court will force it to do so.

a. **Rationale:** Why would the corporation lock itself in with a charter, bylaw or contractual provision; why not simply wait until the particular occasion arises, and then make a voluntary payment to the director or officer? The answer is that the director or officer may not be willing to take the post on this kind of wait-and-see basis. For instance, the director or officer may reasonably fear that after he takes a particular action, corporate control may change to one who is unfriendly to him, who would then cause the corporation to refuse indemnification. (In fact, since even the articles of incorporation or bylaws could be changed after an act by D but before a suit was brought, D's best protection is to have a ***contract*** with the corporation explicitly guaranteeing him indemnification under certain circumstances.)

b. **Must not run afoul of specific statutory prohibition:** A charter, bylaw or contractual provision will only be enforced if it does not run afoul of some explicit ***statutory prohibition***. As we will see in our discussion of permissive indemnification below, most states flatly prohibit indemnification in certain circumstances (e.g., where D acts in bad faith to obtain a wrongful personal financial benefit from the corporation, or D acts with knowing illegality). In such a "statutory prohibition" situation, the court will not enforce even a very explicit mandatory indemnification provision in a charter or contract.

D. **Permissive indemnification:** Virtually all states, in addition to their mandatory-indemnification provisions, allow for ***"permissive"*** indemnification. That is, there is a large zone of circumstances in which the corporation ***may***, if it wishes, indemnify the director or officer, but is not required to do so.

1. **Limits:** However, to prevent corporations from underwriting blatant wrongdoing by those in control, nearly all states place certain ***limits*** on permissive indemnification. That is, each state ***prohibits*** indemnification in certain circumstances. Typically, states prohibit indemnification where:

   (1) D is found to have acted in ***knowing violation*** of a serious law;

   (2) D is found to have received an ***improper financial benefit***;

   (3) D pays a ***fine or penalty*** where the policy behind the law precludes indemnification; or

   (4) the amount in question is a payment made by D to the corporation in a ***derivative action***.

   We will consider various contexts in which even permissive indemnification may be prohibited by the state.

2. **Model Act:** The MBCA's permissive-indemnification provisions are reasonably typical of modern statutes. Therefore, to give you some idea of how the pieces fit together in a typical permissive-indemnification scheme, here is the text of MBCA §8.51:

"§8.51 **Permissible Indemnification**

(a) Except as otherwise provided in this section, a corporation ***may indemnify*** an individual who is a party to a proceeding ***because he is a director*** against liability incurred in the proceeding if:

(1) (i) he conducted himself in ***good faith; and***

(ii) he ***reasonably believed***:

(A) in the case of conduct in his ***official capacity***, that his conduct was in the ***best interests*** of the corporation; and

(B) in all other cases, that his conduct was at least ***not opposed to the best interests of the corporation***; and

(iii) in the case of any criminal proceeding, he had ***no reasonable cause to believe his conduct was unlawful; or***

(2) he engaged in conduct for which ***broader indemnification*** has been made permissible or obligatory under a provision of the ***articles of incorporation***.…

(c) The termination of a proceeding by ***judgment***, order, ***settlement***, or conviction, or upon a plea of nolo contendere or its equivalent, is ***not***, of itself, ***determinative*** that the director did not meet the relevant standard of conduct described in this section.

(d) Unless ordered by a court under §8.54(a)(3), a corporation may ***not indemnify*** a director:

(1) in connection with a proceeding ***by or in the right of the corporation*** [e.g., a derivative action], except for reasonable expenses incurred in connection with the proceeding if it is determined that the director has ***met the relevant standard of conduct*** under subsection

(a); or

(2) in connection with any proceeding with respect to conduct for which he was adjudged liable on the basis that he ***received a financial benefit to which he was not entitled***, whether or not involving action in his official capacity."

a. Delaware: Delaware's permissive indemnification provision contains essentially the same language as MBCA §8.51(a) and (c). Also, it forbids indemnification in suits by or on behalf of the corporation (including shareholders' derivative suits) in which D is found liable to the corporation, unless the court so orders. See Del. GCL, §145(a) and (b).

3. Third-party action: First, let's consider suits brought directly against the director or officer by a ***third party***. In other words, we are not considering actions brought by the corporation against the defendant or officer; nor are we considering ***derivative actions*** (i.e., suits brought "in the name of" the corporation by a shareholder).

a. General rule: As a general rule, most states allow

permissive indemnification so long as the director or officer: (1) acted in ***good faith***; (2) was pursuing what he reasonably believed to be the ***best interests*** of the corporation; and (3) had no reason to believe that his conduct was ***unlawful***. See MBCA §8.51(a)(1).

b. Breach of duty of due care: Most importantly, this means that if a director or officer, while acting on behalf of the corporation, acts ***negligently*** (or even grossly negligently, but not dishonestly) the corporation will be able to indemnify him for his ***expenses*** in defending a third-party suit, and for any ***judgment*** or ***settlement*** he might have to pay.

Example: D is the president and director of Auto Corp. He approves production of a new car, the Nino, without reading a design-and-safety analysis prepared by the company's engineering department. Had D read this report, he would have known that the design was extremely dangerous, in that the car was likely to explode if hit from the rear. P, a passenger in a Nino, is badly burned when just such a collision occurs. P sues D (as well as Auto Corp.) for gross negligence.

Although D has acted with negligence or even with gross negligence, Auto Corp. will probably be allowed to indemnify D for: (1) his expenses (including legal fees) in defending the suit; (2) any judgment he may be required by the court to pay after the trial; and (3) any settlement he might decide to pay instead of going to trial. This is true because D appears to have acted in good faith, in the reasonable belief that he was acting in the best interests of Auto Corp., and with no reason to believe that his conduct was unlawful.

c. Bad faith: But if the director or officer acts in ***bad faith***, then in most states he may ***not*** be indemnified. For instance, suppose that D in the above example reasoned, "I know that this design is unsafe, and that some people will be fried as a result. However, it would cost us more money to make a safe design than we'll have to pay in civil suits for this unsafe design, so let's go with the unsafe one." On these facts, D has clearly not behaved in good faith, so the corporation will be

forbidden to indemnify him, even if it wished to do so (and even if in a narrow financial sense D's decision was indeed in the corporation's best interests.)

i. Delaware agrees: Delaware agrees with this general approach, that a director or officer ***may not be indemnified if she acts in bad faith***. See Del. G.C.L. §145(a), which says that a corporation may indemnify an officer or director ***only*** if he "acted ***in good faith*** and in a manner he ***reasonably believed*** to be in or not opposed to the ***best interests*** of the corporation." The indemnitee must also have had "no reasonable cause to believe his conduct was ***unlawful***."

(1) Provision cannot be overridden: This "no indemnification for bad faith actions" provision is not just a default rule — it is a rule that ***cannot be overridden*** no matter what the corporation does.

d. Illegality: Similarly, if the case is a ***criminal*** proceeding, the corporation may not indemnify D if D had reasonable cause to believe that his conduct was ***unlawful.***

Example: D, a director of XYZ Corp., knowingly authorizes a company executive to pay bribes to an official of a foreign government, in violation of the federal Foreign Corrupt Practices Act. D is then charged with violating the act. If D is convicted, XYZ will not be permitted to indemnify D either for his legal expenses or any fine that he is required to pay.

e. Improper personal benefit: Most states do not allow a corporation to indemnify a director or officer who has received an ***improper personal benefit*** from his actions. See, e.g., MBCA §8.51(d)(2).

i. Insider trading: For instance, a director or officer who is found liable for ***insider trading*** probably may not be indemnified by the corporation either for litigation expenses, fines, settlements or judgments paid. This is true even if the corporation itself has not been injured by the

trading. See Official Comment 4 to MBCA §8.51. (Also, in the insider trading situation D might have an additional problem because he was not acting ***in his official capacity***, something that many of the statutes require for indemnification.)

4. **Derivative litigation:** Now, let us turn to suits brought ***by or on behalf of the corporation***. Here, we are principally interested in ***derivative suits*** (since a corporation that brings a direct action against a director or officer is unlikely to be willing to make permissive indemnification payments). Since a derivative suit involves a charge that the corporation has itself been injured by the defendant's actions, states are less likely to allow the corporation to indemnify than in the case of third-party actions discussed above.

   a. **Settlements or judgments:** Thus the vast majority of states do ***not*** permit the corporation to indemnify a director or officer for a ***judgment*** on behalf of the corporation, or for a ***settlement*** payment made by the defendant to the corporation. See, e.g., MBCA §8.51(d)(1); Del. GCL §145(b). This rule is easy to understand: if indemnification were allowed in the case of judgment or settlement on behalf of the corporation, there would be a ***circular recovery*** — the corporation would be receiving the judgment or settlement with one hand and paying it out again with the other hand in the form of indemnification.

   b. **Expenses:** On the other hand, the defendant may have a somewhat easier time getting indemnified for his ***litigation expenses*** (including attorney's fees). Here, most statutes seem to permit these expenses to be indemnified if D has ***settled*** the case with the corporation, but do not permit them if D has been ***found liable*** by the court. In a state making this distinction between settlement and judicial finding of liability, the director or officer will thus have a powerful ***incentive*** to ***settle*** if his legal bills have been extensive.

5. **Fines and penalties:** Suppose the director or officer is ***fined*** or

required to pay a ***penalty*** or ***punitive damages***. May he be indemnified for these? In general, the answer is "yes," so long as the defendant meets the other requirements for permissive indemnification (e.g., that he behaved in good faith, and that he did not have reason to believe that his conduct was illegal).

E. Who decides: Observe that the corporation's right to indemnify a defendant depends on one or more ***questions of fact***, such as: (1) whether D acted in good faith; (2) whether D reasonably believed that he was acting in the best interests of the corporation; and (3) whether D had reason to believe that his conduct was illegal. Therefore, the question becomes, ***who decides*** these issues of fact?

1. Court proceeding: Sometimes, these factual issues will be answered ***by the court*** as part of the basic action for which indemnification is later sought. Thus if the trial judge makes specific findings of fact in deciding against the defendant (e.g., "I conclude that D approved the automobile design plans with knowledge that they posed grave safety risks"), this finding will be binding. But the mere fact that D ***lost*** the case will ***not necessarily*** dispose of these factual issues.

Example: Consider the facts of the basic automobile example *supra*, p. 345. Suppose further that the case goes to the jury, and the jury finds D liable on a negligence theory. This verdict does not dispose of the issue whether D acted in good faith or the issue whether he acted in what he reasonably perceived to be the best interests of the corporation. Therefore, someone else will have to decide whether D qualifies for permissive indemnification.

2. Statutes vary: When the basic suit does not dispose of these entitlement issues, statutes vary as to who may decide them. Typically, ***independent members*** of the ***board of directors*** (i.e., those who were not themselves involved in the action) may make these decisions, assuming that they make up a quorum of the total board. See, e.g., MBCA §8.55(b)(1). Also, in most states the ***stockholders*** may decide them.

a. Independent legal counsel: Additionally, some but not all

statutes permit this decision to be made by ***"independent" legal counsel***. See, e.g., Del. GCL §145(d)(3); MBCA §8.55(b)(2).

i. **Regular law firm:** Probably the corporation's regular outside law firm is not "independent" for this purpose, so a firm that has not recently done work for the corporation or for its insiders must be called in specially for this task.

F. **Advancing of expenses:** Not only is litigation expensive, but the legal bills must normally be paid as they are incurred. A director or officer who does not have the money to pay attorney's fees as the action proceeds would therefore find little comfort in the knowledge that at the end of the action he could obtain indemnification. Therefore, most statutes allow the corporation to ***advance*** to the director or officer money for counsel fees and other expenses as the action proceeds.

1. **Promise to repay:** Typically, the statutes require that the director or officer ***promise*** in writing to repay these advances if he is ultimately found not entitled to indemnification. See, e.g., Del. GCL §145(e).

2. **Financial ability:** As long as the director or officer makes this promise, the corporation may generally make the advance even if there is reason to believe that the defendant would not be ***financially able*** to make the repayment. A few states require the defendant to post ***collateral*** to guarantee repayment, but most do not, on the theory that this would unfairly discriminate between poor and rich directors or officers. See, e.g., MBCA §8.53(b), which says that "[t]he undertaking [to make repayment] … must be an unlimited general obligation of the director but ***need not be secured*** and may be accepted ***with-out reference*** to the ***financial ability*** of the director to make repayment."

G. **Insurance:** Nearly all large companies, and many small ones, today carry Directors' and Officers' ("D&O") ***liability insurance***. D&O policies are becoming as important as indemnification for directors and officers who are sued in connection with their duties.

1. **Typical policy:** The typical D&O policy has two parts:

   a. **Corporate reimbursement:** First, the ***"corporate reimbursement"*** part reimburses the ***corporation*** for indemnification payments it makes to a director or officer. Thus the corporation is made whole (at least up to the policy limits) when it indemnifies the director or officer, a fact which is likely to make the corporation much more liberal in granting indemnification in a particular instance than if the corporation were paying out of its own pocket.

   b. **Personal coverage:** Second, the ***"personal coverage"*** reimburses the director or officer directly for his losses (litigation expenses, settlements or judgments) to the extent that he is not indemnified by the corporation. This part of the policy comes into play if the corporation is unable to indemnify the individual (e.g., because the corporation is insolvent, or because indemnification on the particular claim would be prohibited by statute), or if the corporation is unwilling to indemnify in a circumstance where it could do so.

2. **Deductibles:** The D&O policy usually has a ***deductible*** (typically less than $10,000) for each officer or director as to the "personal coverage" part. Also, there is usually a much larger deductible for the "corporate reimbursement" part.

3. **Premium:** Usually the corporation, not the individual, pays the entire premium.

4. **Exclusions:** Nearly all D&O policies contain some important ***exclusions.*** Most policies contain at least the following major exclusions:

   a. **Personal profit or advantage:** A claim based on the individual's gaining a ***personal profit or advantage*** to which he was not legally entitled. (For instance, a claim that D usurped a corporate opportunity, or engaged in self-dealing by selling property to the corporation at an inflated price, or a claim that D improperly spent corporate funds to entrench himself in office, would all presumably be excluded under this

clause.)

b. Active and deliberate dishonesty: A claim which results in a judgment that the insured acted with ***"active and deliberate dishonesty."*** (Thus knowing and willful ***violations of law***, such as the payment of bribes or of illegal campaign contributions, would be excluded.)

c. Illegal remuneration: A claim for return of ***illegal remuneration***, if a court agrees that remuneration was illegal. (For instance, compensation that is ruled by a court to have been ***excessive*** won't be covered.)

d. Libel and slander: A claim for ***libel*** or ***slander***.

e. Securities laws: A claim for return of ***short-swing profits*** under §16(b) of the Securities Exchange Act of 1934 (*supra*, p. 305).

f. Fines penalties and punitive damages: ***Fines*** and ***penalties*** in ***criminal cases***. In a ***civil*** case, fines, penalties and punitive damages will also be uninsurable if insurance on them would be a violation of ***public policy***. (This will often be the case, since a fine, penalty or punitive damage award has as its main purpose ***deterrence*** rather than compensation, and the ability to insure against loss will remove much of the deterrent effect of that loss. See Clark, p. 670.)

5. Generally allowed: Most states explicitly ***allow*** the corporation to purchase D&O insurance.

a. May cover non-indemnifiable costs: Most importantly, a corporation may buy D&O insurance to cover a director's or officer's expenses ***even where those expenses could not be indemnified***. For instance, MBCA §8.57 allows use of insurance to cover an individual "whether or not the corporation would have power to indemnify or advance expenses to him against the same liability under this subchapter."

6. Practical effect: Of course, many of the kinds of expenses that the corporation is forbidden to give indemnity for under most

statutes, are also ***excluded*** from the typical D&O policy. For instance, just as the corporation may not generally indemnify for self-dealing (see *supra*, p. 344), so the typical D&O policy will not cover self-dealing. Similarly, knowing and culpable ***violations of law*** typically cannot be indemnified or insured against. Why, then, is it worthwhile to have insurance?

a. Individual's perspective: From the individual's perspective, there are some important instances in which insurance would cover an expense that could not be indemnified.

i. Derivative actions: Most significantly, money paid ***to the corporation*** as a ***judg-ment*** or ***settlement*** in a ***derivative action*** will usually be coverable by insurance (assuming the case did not involve blatant self-dealing or knowing illegality), even though such derivative action settlements and judgments are almost never indemnifiable (see *supra*, p. 346).

ii. Fact-finding: Second, whereas the corporation must generally make a ***formal written finding*** of indemnifiability before it may make final indemnification payments to the defendant (e.g., a report by an independent legal counsel, see *supra*, p. 347), no such formal fact-finding is required prior to insurance coverage — the insurer usually makes its decision about whether a particular claim is covered on a much less formal negotiated basis.

iii. Legally able but practically unable or unwilling: Finally, even if the corporation would be legally entitled to indemnify D for a particular loss, the corporation may be unable as a practical matter to do so (e.g., because it is insolvent), or may simply be ***unwilling*** to do so, in which case insurance is worthwhile. Clark, p. 674.

b. Corporation's perspective: From the corporation's perspective, the availability of insurance has two major virtues: (1) the corporation can avoid having to pay out more than a certain amount to cover directors' and officers' liability problems in any particular year (whereas if it has a broad

indemnification policy, it may suddenly find itself with massive indemnification liability); and (2) the availability of insurance may allow the corporation to get ***better directors and officers*** than it would be able to get if it did not furnish them with insurance. See Clark, pp. 673-74.

Quiz Yourself on
SHAREHOLDERS' SUITS *(ENTIRE CHAPTER)*

74. Chateau Marmoset, Inc., is a winery. Its board of directors wants to reduce the market price of Chateau Marmoset's shares (so insiders can buy the shares up more cheaply). Therefore, the board refuses to declare a dividend. This does, in fact, drive down the price of Chateau Marmoset stock. A Chateau Marmoset minority shareholder, Cher Donnay, brings suit against the directors to force them to pay a dividend.

(a) If you represent Cher, would you prefer that the court characterize your suit as a derivative suit, or a direct suit?

____

(b) How will the court in fact characterize your suit?

____

75. The Peter Minuit Real Estate Development Corp. has seven directors. One of them, Chief Floating Zone, owns an island he wants the company to buy from him for $24 and some subway tokens. (All directors are aware that Floating Zone owns the island.) There is some evidence before the board that the price is perhaps 20-30% above market rates. Five of the seven directors (one of whom is Floating Zone himself) vote to approve the transaction; the other two dissent. The transaction goes through. Manny Hattan, a Peter Minuit shareholder, bring a derivative claim against Floating Zone for self-dealing, and against the other four board members for breaching their duty of care in approving the high-priced transaction. (Hatten has not first made a demand on the board that they bring the suit instead of him.) The company files a motion to dismiss for failure to make a demand on directors. Assume that Delaware law is to be followed.

(a) What argument should Hatten make about why demand on the

board should be excused? ______________________________

(b) Will this argument succeed? ______________________________

76. Snow White is a shareholder of Seven Dwarfs Microcomputers, Inc., which has seven directors. The Munchkinsoft Computer Co. makes a secret offer to the board of Seven Dwarfs to buy Seven Dwarfs at $25 a share. The directors instead collectively ask Munchkinsoft to give each director a consulting contract; in return, the directors promise to recommend to the shareholders that they accept *$20* a share for the Seven Dwarfs stock. The sale is approved at the $20 figure in part due to the directors' recommendation (which doesn't mention the $25 offer or the consulting contracts). The true facts about the recommendation later emerge. Snow White brings a derivative suit against the directors without first making a demand on them that they remedy the situation. The directors claim that the suit should be dismissed due to failure to make a demand on directors.

(a) Assume that Delaware law applies. What result?

____

(b) Assume that the MBCA applies. What result?

____

77. Peter Pan is a shareholder of the Fairy Dust Pharmaceuticals Corp. Three of Fairy Dust's seven directors, Wendy Darling, Captain Hook, and Tinkerbell, usurp a corporate opportunity of Fairy Dust's. Peter Pan, intending to file a derivative suit against them, makes a demand on the directors first. They appoint a special litigation committee, comprised of Wendy Darling, Tinkerbell, and a retired judge, Oliver Motor-Holmes. After a thorough investigation of the facts, the committee recommends that Fairy Dust not pursue a claim. Peter Pan files the derivative claim, and the directors respond by citing the committee's recommendation and filing a motion to dismiss. Will the court honor the committee's recommendation? ______________________________

78. Same basic facts as the prior question. Now, assume that only Wendy Darling is charged with usurping the corporate opportunity. All members of the board (with Wendy abstaining) vote to appoint a 3-member litigation committee, consisting of Captain Hook, Tinkerbell and Motor-

Holmes. (There are no significant personal relationships between any of these three and Wendy.) The committee makes an extensive investigation into the facts. It concludes that Wendy has indeed acted on both sides of the transaction, did not make disclosure of the conflict to the board, and improperly benefited. However, the committee also formally concludes that "Although the suit might well be successful in recovering $100,000 from Wendy, the suit would cause considerable distraction to the company's officers and board, and the probable recovery would likely be outweighed by the negative impact of these distractions. Therefore, we recommend that the suit be dismissed."

(a) In most states, would the court accept the committee's recommendation? ____________________________

(b) In a state following the MBCA, would the court accept the committee's recommendation? ____________________________

79. Hannibal Lechter Foods, Inc., makes a popular meal extender for cannibals, "Manburger Helper" ("… when you need a helping hand.").[2] The corporation is incorporated in (and based in) the mythical state of Atlantis. Robinson Crusoe, a 1% shareholder, believes that the directors are cooking the books; however, they refuse to allow him to see the corporation's books to find out if he's right. Nineteen other shareholders have the same problem. Among them, Crusoe and the other nineteen shareholders own 3% of the corporation's shares. When they sue the corporation in Atlantis state court to enforce their state-law right to inspect the books, the corporation asks that they be required to post bond for the corporation's litigation expenses. The Atlantis security-for-expenses statute is mandatory when the plaintiffs in a derivative suit own less than 10% of a corporation's outstanding shares. Will Crusoe and the other plaintiff/ shareholders have to comply with the statute?

____

80. Catherine of Aragon is one of the directors of Henry VIII Dating Service, Inc. In her position as board member, she encourages Henry VIII to acquire another company, Marie Antoinette Cakes, Inc. Unbeknownst to the shareholders or directors of Henry VIII, Catherine is a large, secret shareholder in Marie Antoinette. Catherine honestly (and reasonably) believes that the acquisition, at the proposed price, will be beneficial to

Henry VIII. After the acquisition goes through, a Henry VIII shareholder, Anne Boleyn, brings a derivative suit against Catherine, alleging that Catherine violated her duty of loyalty to Henry VIII by not disclosing the conflict. Catherine spends $20,000 litigating the suit; just before it goes to trial, she settles for a payment of $50,000 to the corporation. Henry VIII's charter authorizes indemnification of any director "for any liability which the director may have to the corporation for any breach of any obligation to the corporation, regardless of whether the director shall have acted in good faith." Catherine wishes to have Henry VIII indemnify her for both her $20,000 in litigation expenses and her $50,000 in settlement payments. The corporation wishes to pay these sums to Catherine, but wants to know whether it may properly do so.

(a) Under the prevailing approach, what result?

____

(b) Under the MBCA, what result? ______________________________

(c) Assume now that the case went to trial. The court found that Henry VIII had paid a price that was $50,000 higher than a "fair" price for Marie Antoinette Cakes, and that this was due in part to Catherine's urging of the transaction, coupled with her failure to disclose her secret ownership interest in Marie Antoinette. The court therefore entered a judgment for $50,000 against Catherine in favor of Henry VIII. Catherine now seeks indemnification from Henry VIII for the $50,000 judgment, plus her litigation expenses (now $30,000). Henry VIII is willing to pay these sums. What, if anything, may Henry VIII properly pay her, under the MBCA? ______________________________

Answers

74. (a) You'd rather it be direct. A derivative suit has to jump many more procedural hurdles. For instance, demand has to be submitted to the board, and in most states if the board makes a reasonable inquiry and concludes that the claim has no merit, the court will probably terminate the action. Also, the plaintiff often has to post security for expenses, and the court has to approve any settlement. A direct action typically does not suffer from any of these shortcomings. [322]

(b) As direct. A case is a derivative suit only where the primary harm is to the corporation, not the individual plaintiff shareholder. Here, Donnay is complaining of an injury to her personally as a shareholder (failure to pay her dividends), not an injury to the corporation. The vast majority of derivative cases are against directors and/or officers for breaching their duties of care and loyalty to the corporation (e.g., wasting assets, self-dealing, excessive compensation, usurping a corporate opportunity). [320] That isn't what happened here. In general, a suit alleging that insiders have taken an action whose motive or principal effect was to injure a minority shareholder will be treated as direct.

75. **(a) That demand would be futile, because the claim is that a majority of the board has breached its duty of care, and the board will almost certainly conclude that a claim of board-wrongdoing has no merit.** It is indeed true that if the court becomes convinced that demand would be futile, the court will excuse the demand. [326] It's also true that in general, if the complaint charges a majority of the board with wrongdoing, the court is more likely to find demand to be futile than where only one board member, or a non-board-member, is charged with wrongdoing. [326] However (as discussed in part (b) to this answer), a Delaware court is likely to conclude that the wrongdoing charged here is not serious enough to excuse demand.

(b) No, probably. Delaware makes it very difficult to have a suit treated as demand-excused. The fact that a majority of the board approved the transaction doesn't, in and of itself, mean that demand on the board would be futile (says Delaware). [327] Demand will not be excused unless P shows in advance a reasonable likelihood that the board either: (1) was not disinterested or not independent; or (2) was not entitled to protection of the business judgment rule for its approval. [326]

There's no evidence of (1) (lack of disinterestedness or independence) on these facts. As to (2), the slightly-high price was not enough to make the board's approval "irrational," which is what would be required for an informed and distinterested board to lose protection of the business judgment rule. So the case will be dismissed until Manny makes a demand on the board. In other words, a charge that a majority of the board has violated its duty of care (as opposed to a charge that it has violated its duty of loyalty) will generally not be enough in Delaware to

make the case demand-excused, unless there's substantial evidence of gross negligence or true irrationality. (A New York court, by contrast, would probably excuse demand here, merely from the fact that a majority of the board is charged with breach of the duty of care.)

76. (a) The demand will be excused, so the case won't be dismissed. As the prior question indicates, the main exception to the requirement of a demand on the board is where demand would be futile. Although Delaware makes it harder than most states to get a finding of futility, a claim (backed by some evidence) that a majority of the board has violated its duty of *loyalty* will suffice. Here, that's the case: all the directors have been offered lucrative consulting contracts with Munchkinsoft, in return for which they seem to have violated their duty to seek the best deal for the Seven Dwarfs' shareholders. As a result, Snow White needn't fulfill the demand-on-directors requirement.

(b) The demand must be made. The MBCA, in §7.42(1), requires that a demand be made on the board in all cases, no matter how futile it would be. [335] (On the other hand, once the demand is made and the plaintiff waits the 90 days required by §7.42(2), the court won't dismiss the action even if the board so recommends, unless the court believes that the independent directors have "determined in good faith after conducting a reasonable inquiry upon which [their] conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation." MBCA §7.44(a). [335] So if the directors do a complete whitewash, the court will let the action proceed.)

77. No, because the members of the committee weren't "independent" or "disinterested." When the plaintiff in a derivative suit makes a demand on directors, the directors needn't make their own decision on whether to pursue the claim. They can, and sometimes do, leave the decision in the hands of a "special litigation committee." When they do so, and the committee recommends that the corporation not pursue the claim, the issue becomes whether the committee's recommendation is protected by the business judgment rule (in which case the motion to dismiss the claim will be granted). While states differ as to the deference courts should pay to committee recommendations, they all agree that each member of the committee must be "independent" from the defendants, and must not have any interest of their own in the transaction under attack ("disinterested").

[329] See, e.g., MBCA §7.44(b)(2). Here, two of the three committee members were themselves defendants charged with serious wrongdoing (breach of the duty of loyalty), so they're not disinterested. As a result, their recommendation isn't subject to the business judgment rule, and the court will deny the motion to dismiss.

78. **(a) Yes, probably.** Most courts look principally at the committee's independence (see prior answer), disinterestedness (against see prior answer), good faith, and thoroughness in investigating. If the court is satisfied that the committee was independent, was disinterested, made a good-faith effort to reach a conclusion about what was best for the corporation, and investigated the available facts with reasonable thoroughness, the court will probably accept the committee's recommendation, without inquiring into the substantive validity of the suit. [330] Since the committee here seems to meet all these conditions, the court will likely accept its conclusions.

(b) Yes. MBCA §7.44(a) says that a derivative proceeding "shall" be dismissed by the court if "one of the groups specified in [other sub-sections] has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation." [335] One of the groups that this section refers to is "a committee consisting of two or more independent directors appointed by majority vote of independent directors present at a meeting of the board of directors." The three committee members here are "independent," because they have no personal relationships with the person charged with wrongdoing (Wendy), and are not themselves charged with wrongdoing. See Official Comm. to §7.44, "1. The Persons Making the Determination." Since all directors (and thus a majority of "independent" directors) voted to have the three elected to the committee, the committee qualifies. The facts don't indicate any reason to believe that the committee acted in other than good faith (for instance, there's no indication that they covered up their own misdeeds), and the facts tell us that the committee made a more-than-"reasonable" inquiry. So the court will not second-guess the committee's conclusion that the suit would not be in the corporation's best interests, and will dismiss the suit on the corporation's motion.

79. **No, because the suit isn't derivative, it's direct.** Security-for-expenses

statutes generally require that “small shareholder” plaintiffs in derivative suits post a bond (or other security) for the corporation’s litigation expenses, which the plaintiff will have to pay if he loses. Not all states have such statutes; however, even in the ones that do, only *derivative* suits are covered, not direct ones. [336] Here, Crusoe and the other shareholders are claiming that their *own* right to inspect the corporation’s books has been violated; they aren’t claiming that the corporation itself has been wronged. Therefore, the claim is direct, not derivative, so the security-for-expenses statute won’t require the plaintiffs to post a bond (or other security) for the corporation’s litigation expenses.

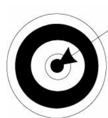
80. (a) The $20,000 in expenses, but nothing towards the $50,000 settlement amount. The vast majority of states do not permit a corporation to indemnify a director or officer for a settlement payment made by the defendant to the corporation at the conclusion of a derivative suit. [346] The reason is that if indemnification were allowed, there would be a circular recovery — the corporation would be receiving the settlement with one hand and paying it out again with the other hand as indemnification. However, most states *do* permit the defendant to be indemnified for his litigation expenses, if the derivative suit has been settled. [346]

(b) Same as in part (a) ($20,000 for expenses, only). Under MBCA §8.51(d)(1), “a corporation may not indemnify a director: (1) in connection with a proceeding by or in the right of the corporation, except for ***reasonable expenses*** incurred in connection with the proceeding if it is determined that the director has met the relevant standard of conduct under subsection (a).…” So no matter what Catherine’s conduct was, she can’t recover the settlement itself, since this is a “proceeding by or in the right of the corporation” (i.e., a derivative suit.) (The *court* still has discretion to *order* indemnification, under the “fair and reasonable” test of §8.54(a)(3), but it’s unlikely that the court will use this discretion, and the corporation may not make the indemnification payment without a court order.)

On the other hand, Catherine probably *can* recover the litigation expenses. These are clearly “reasonable expenses incurred in connection. …” The issue is whether Catherine’s conduct met the requirements of §8.51(a). That subsection requires that she have: (1) conducted herself in

"good faith"; and (2) "reasonably believed … in the case of conduct in [her] official capacity, that [her] conduct was in the best interests of the corporation." The facts tell us that (1) is satisfied, and her belief that the acquisition would be a good one for Henry VIII probably means that (2) is satisfied as well. Therefore, Catherine can probably recover her litigation expenses.

(c) Nothing. MBCA §8.51(d)(2) prohibits the company from indemnifying a director "in connection with any proceeding with respect to conduct for which [the director] was ***adjudged liable*** on the basis that he ***received a financial benefit to which he was not entitled***, whether or not involving action in his official capacity." This applies here: the court has found a breach of the duty of loyalty, leading to an unduly high price being paid, which price was shared in by Catherine. Therefore, without a court order the company may not even pay Catherine's litigation expenses, let alone indemnify her for the judgment. (The court might still order that Henry VIII reimburse the expenses, under §8.54(a)(3), if this would be "fair and reasonable"; but the court does not have discretion to order indemnification for the judgment under any circumstances, under that same provision.)



Exam Tips** on* ***SHAREHOLDERS' SUITS, ESPECIALLYDERIVATIVE SUITS

☛ Whenever the facts involve a shareholder suit, first determine whether the suit should be characterized as a ***direct action*** or a ***derivative action***.

- ☞ Remember that if the injury is primarily to some or all s/h's "personally," the suit to redress it is a ***direct*** action. Here are kinds of suits that are usually "direct":
  - ❑ suits to enforce the s/h's ***voting rights***;
  - ❑ suits to ***compel payments of dividends***;

- ❑ suits to ***prevent oppression of or fraud*** on minority s/h's;
- ❑ suits to ***compel inspection*** of the corp's books and records.

☞ Conversely, a ***derivative*** action is the exclusive remedy where the alleged harm is done primarily to the ***corporation***, rather than to an individual s/h. Examples of suits that are generally derivative:

- ❑ suits claiming breach of the ***duty of care***;
- ❑ suits claiming breach of the ***duty of loyalty*** (e.g., suits claiming self-dealing, usurpation of a corp. opportunity, or excessive compensation).

☛ If the action is derivative, confirm that the requirements for a derivative action have been met. In particular:

☞ Verify that either the ***"contemporaneous ownership"*** rule is satisfied, or that some exception applies. Thus P must normally have ***already owned his shares at the time of the transaction of which he complains***. But there are two exceptions:

☞ where the wrong began before P brought his shares, but ***continued after*** P bought (the ***"continuing wrong"*** exception); or

☞ where P acquired his shares by ***"operation of law,"*** and his ***predecessor owned*** the shares before the wrongdoing (the "operation of law" exception). Shares which P acquired by ***inheritance*** are often part of the exam fact pattern, and fall within this exception.

☞ Check to see whether P has made a ***demand*** on the directors to redress the improper action. If not, determine whether demand is ***excused*** because it's ***likely to be futile*** (though not all states excuse demand even when futile).

☞ Keep in mind that in many states, demand is excused as futile where ***all or a majority*** of the ***board*** is ***charged*** with breach of the duty of ***due care*** or of the duty of ***loyalty***.

Example: Trucking Corp. runs a trucking business. Its board has 15 members. Management has a consultant prepare a report that says that if the corp. doesn't buy $1 million worth

of new trucks within the next year, the company will lose business and probably become insolvent. The report is given to every member of the board, but only 5 read it. The board unanimously votes not to buy new trucks, and to spend the $1 million available to buy another business. Trucking Corp. becomes insolvent shortly thereafter for lack of new trucks. S, a s/h throughout the relevant period, brings a derivative action against those board members who didn't read the report, for breach of the duty of care in not buying the trucks. In many states, demand on the board will be excused, because this demand would likely be futile since a majority of the board members are being accused of a breach of the duty of care.

☞ If P has made a demand on the board, and the board ***rejects*** the demand, the board's decision will generally receive the ***protection of the business judgment rule*** (so that as long as the decision not to bring the litigation is ***rational***, P will not be allowed to continue with his derivative action).

☞ But the court will allow P's suit to ***go forward*** despite the board's rejection of the demand, if either: (1) the ***board significantly participated*** in the alleged wrong; or (2) the directors who voted to reject the suit were ***dominated or controlled by the alleged wrongdoers***.

☞ Look for situations in which the board has appointed a special ***committee*** to evaluate the derivative action, and the committee has recommended dismissal. Confirm that the members of the committee are ***truly independent*** of the directors accused of wrongdoing — if they're not, the derivative action should be allowed to proceed despite the committee's recommendation.

Example: The 5 directors of Corp. (most of whom are part of management) are fearful of a hostile takeover attempt. These 5 directors therefore vote to sell off valuable corporate assets at below-market prices, solely to make Corp. a less attractive target. The board then votes to expand to 9 members, and to stagger the terms so that only 3 directors can be replaced each year. The 4 new directors are all close friends of the existing

directors. P brings a derivative action against Corp for damages from the asset sales. The board votes to create a litigation committee consisting of the 4 new directors. The committee votes to recommend dismissal of P's suit. You should say that the court should let the suit proceed, because the committee was not truly independent — its members were all close friends of the original directors accused of the wrongdoing.

☛ Look out for questions that require you to say whether a corp's ***indemnification*** of its officers or directors was proper.

☞ Recall that nearly all states ***permit*** the corp to indemnify any director or officer whose position is ***upheld*** in litigation, so questions on this fact pattern are easy. (In fact, most states ***require*** the corp. to indemnify in this "successful defendant" situation.)

☞ Conversely, remember that most states do ***not permit*** an agreement to indemnify a director or officer whose position is ***not upheld*** (e.g., a dir. or off. who's found liable to the corp. in a derivative action).

☞ Where the action is ***settled*** by means of a payment by the dir/off to the corp., usually state statutes say that the dir/off ***can*** be indemnified for his ***litigation expenses***, but ***can't*** be indemnified for the ***settlement payment***.

Example: Veep, a v.p. of Corp., is sued in a derivative action in which P says that Veep entered into an unfairly favorable contract to buy property from Corp. Veep spends $30,000 on legal fees, then settles by paying $20,000 to Corp. Corp. can probably indemnify Veep for the $30,000 legal fees, but not the $20,000 settlement.

☞ Make sure that the ***decision*** about whether to indemnify is made by a ***sufficiently independent party.*** Thus directors closely affiliated with the defendant(s) can't decide to allow the indemnification payment — a ***committee*** of independent directors (i.e., directors not charged with wrongdoing and independent of those who are so charged), should make this decision.

Example: P brings a derivative suit charging all members of Corp's board with selling Corp's assets at an unfairly low price to avoid a

hostile takeover. The suit is settled with each board member paying $10,000. The entire board votes to pay the litigation expenses, including legal fees, of each board member. Probably this indemnification is invalid — since every board member was charged with wrongdoing, they couldn’t make an arms’ length decision to indemnify themselves.

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1. On the other hand, the court concluded, this was not yet a valid *direct* claim either, because the merger as extended had not yet closed, so the plaintiffs' claim had not yet "ripened." Once the merger closed, then plaintiffs could bring their direct claim.

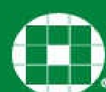
2. Yes, we know you've seen this cheap pun (and this cheap basic fact pattern) before (p. 126). But we've varied the facts this time.

EXAMPLES & EXPLANATIONS

Corporations

Eighth Edition

Alan R. Palmiter



Wolters Kluwer

PART IV

Corporate Fiduciary Duties

CHAPTER 11

Corporate Fiduciary Duties — An Introduction

At the heart of corporate law lie duties of trust and confidence—fiduciary duties—owed by those who control and operate the corporation's governance machinery to the body of constituents known as the "corporation." Directors, officers, and controlling shareholders are obligated to act in the corporation's best interests, which traditionally has meant primarily for the benefit of shareholders—the owners of the corporation's residual financial rights.

State courts, not legislatures, have been the primary shapers of corporate fiduciary duties. Judicial rules balance management flexibility and accountability, producing often vague and shifting standards. The American Law Institute has contributed the Principles of Corporate Governance (see §1.2.4) to articulate and provide guidance on corporate fiduciary duties and the standards of judicial review they entail. Fiduciary duties fuel the ongoing debate over the function and responsibility of the corporation in society.

This chapter introduces the theory and nature of corporate fiduciary duties (§11.1), gives an overview of the duties of care and loyalty (§11.2), and describes the reality of fiduciary duties in modern corporations (§11.3), particularly as they relate to independent directors (§11.4). The chapter also offers an overview of recent federal legislation—the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010—that introduce a variety of corporate governance reforms in public corporations and thus federalize some corporate fiduciary duties (§11.5).

The other chapters in this part describe corporate fiduciary duties in

specific contexts, as well as the procedures for their enforcement:

- duty of care of directors in making decisions and monitoring corporate affairs, as well as the operation of the business judgment rule and statutory exculpation provisions (Chapter 12)
- duty of loyalty of corporate officials when they enter into self-dealing transactions with the corporation and judicial review for fairness (Chapter 13)
- judicial review of executive compensation under corporate fiduciary law and federal restrictions and disclosure requirements (Chapter 14)
- indemnification of corporate officials under corporate statutes and by agreement and directors' and officers' insurance (Chapter 15)
- duty of loyalty of corporate officials who take business opportunities in which the corporation may be interested and who compete with the corporation (Chapter 16)
- duties in corporate groups, including dealings by parent corporations with partially owned subsidiaries and buyouts of minority shareholders (Chapter 17)
- enforcement of fiduciary duties in derivative suits, including procedural requirements and the board's role in litigation on behalf of the corporation (Chapter 18)

In short, this part focuses on fiduciary duties in the context of business operations. Other chapters focus on fiduciary duties in the context of shareholder voting (Chapter 8), disclosure to shareholders (Chapter 22), securities trading by corporate insiders (Chapter 23), and changes of control (Chapter 39).

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§11.1 THE CORPORATE FIDUCIARY— A UNIQUE RELATIONSHIP

§11.1.1 Analogies to Trusts and Partnerships

What is the corporate fiduciary's relationship to the corporation? Early courts

analogized the corporation to a trust, the directors to trustees, and the shareholders to trust beneficiaries. But modern courts recognize that the analogy is flawed because trustees have limited discretion compared to directors.

Sometimes the corporation, particularly when closely held, has also been analogized to a partnership. But corporate fiduciaries operate in a system that prizes corporate permanence as well as centralized management and the discretion specialization entails. Although some cases have implied partner-like duties for participants in close corporations (see §27.2.2), the cases are exceptions to the broad discretion afforded corporate directors.

In the end, the most that can be said is that directors have a unique relationship to the corporation. The relationship arises from the broad authority delegated directors to manage and supervise the corporation's business and affairs, subject to the rights of shareholders to elect directors.

Duties of Other Corporate Insiders

Courts have generally imposed on corporate officers and senior executives the same fiduciary duties imposed on directors. MBCA §8.41. Those employees who are officers in name but have no actual authority, as well as other employees, have traditional duties of care and loyalty as agents of the corporation. In addition, corporate officers and employees have a duty of candor that requires them to give the corporation (the board of directors or a supervisor) information relevant to their corporate position.

In general, persons retained by the corporation do not have corporate fiduciary duties. For example, an attorney who advises a majority shareholder in an unfair squeezeout of minority shareholders is not bound by fiduciary duties to the corporation, though the attorney can be liable for tortious aiding and abetting of a fiduciary breach by the majority shareholder. See *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001) ("aiding and abetting" breaches of fiduciary duty have four elements: (i) the existence of a fiduciary relationship, (ii) a breach of the fiduciary's duty, (iii) knowing participation in the breach by the non-fiduciary defendants, and (iv) damages proximately caused by the breach).

§11.1.2 Theory of Corporate Fiduciary Duties

The genius of the U.S. corporation lies in its specialization of function. The

corporation separates the risk-taking of investors and the decision-making of specialized managers. This separation creates an inevitable tension.

- **Management discretion.** The efficiency of specialized management suggests that managers should have broad discretion. Giving shareholders (and courts) significant oversight would undermine this premise of the corporate form. In cases of normal business decision-making, judicial abstention is appropriate.
- **Management accountability.** Entrusting management to nonowners suggests a need for substantial accountability. As nonowners, managers have natural incentives to be lazy or faithless. Although shareholder voting constrains management abuse, voting is episodic. Without supplemental limits, management discretion would ultimately cause investors to lose confidence in the corporate form. In cases of management overreaching, judicial intervention is the norm.

Corporate fiduciary law must resolve this tension. Like much of corporate law, fiduciary rules aim to minimize "agency costs"—the losses of investor-owners dealing through manager-agents.

§11.1.3 To Whom Are Fiduciary Duties Owed?

Corporate directors are said to owe fiduciary duties to the "corporation," not the particular shareholders who elected them. Some courts and many commentators assert that fiduciary rules thus proceed from a theory of maximizing corporate financial well-being by focusing on *shareholder wealth maximization*. The theory posits that any fiduciary rule—whether governing boardroom behavior or use of inside information—must maximize the value of shareholders' interests in the corporation. As residual claimants of the corporation's income stream, shareholders are the most interested in effective management. Under this theory, the corporation's other constituents such as bondholders, creditors, employees, and communities where the business operates are limited to their contractual rights and other legal protections. See *Equity-Linked Investors, LP v. Adams*, 705 A.2d 1040 (Del. Ch. 1997) (finding that new borrowing by financially troubled firm did not violate rights of preferred shareholders, which "are contractual in nature").

To the extent other constituents have unprotected interests inconsistent with those of shareholders, the interests of shareholders prevail—a *shareholder primacy* approach.

In most instances, courts have said that corporate fiduciary duties run to equity shareholders. When the business is insolvent, however, these duties run to the corporation's creditors—who become the corporation's new residual claimants. See *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del. Ch. 1992). When the corporation is on the verge of insolvency, the question arises whether directors should be allowed to take risks to return to solvency (for the benefit of shareholders) or avoid risks to preserve assets (for the benefit of creditors). Some cases suggest that the board's role shifts in such circumstances from being an "agent for the residual riskbearers" to owing a duty to the corporate enterprise. *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*, No. 12150 (Del. Ch. 1991).

Dodge v. Ford Motor Co.

Despite its prevalence, the theory of shareholder wealth maximization has gaps. For example, the case most often cited as supporting the theory may actually have turned on nonshareholder concerns. In *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919), the Michigan Supreme Court reviewed Ford Motor's decision to discontinue paying a special $10 million dividend, ostensibly to finance a new smelting plant while paying above-market wages and reducing the price of Ford cars. Minority shareholders claimed the decision was inconsistent with the fundamental purpose of the business corporation—to maximize the return to shareholders. The court agreed and faulted Henry Ford for reducing car prices and running Ford Motor as a "semi-eleemosynary institution and not as a business institution." The court ordered the special dividend, though curiously refused to enjoin Ford's expansion plans because "judges are not business experts."

At first blush, the case seemed to turn on Ford's stated view that his company "has made too much money, has had too large profits … and sharing them with the public, by reducing the price of the output of the company, ought to be undertaken." Nonetheless, more was below the surface. The plaintiff Dodge brothers (former suppliers of car chassis and motors to Ford Motor) hoped to use the special dividend to finance their own start-up car manufacturing company, and Henry Ford's dividend cutback was meant to forestall this competition, despite the attendant benefits of competition to

the car-buying public and Michigan's auto industry. The court's decision to second-guess perhaps the most successful industrialist ever is at odds with the general judicial deference to management, as well as with the Michigan court's specific observation that Ford Motor's great success had resulted from its "capable management."

Using corporate law, the court advanced a social agenda. Fixing on snippets from Henry Ford's public relations posturing, the court labeled him an antishareholder altruist. This allowed the court to order Ford to fund the Dodge brothers' new car company, thus injecting some competitive balance into the expanding auto industry and ultimately into Michigan politics. Soon after, the Dodge brothers parlayed their court victory into a sizeable buyout of their Ford Motor holdings. (It is worth noting that no other minority shareholders participated in the case, though Henry Ford eventually bought them out, too.) Ironically, the case so often cited as declaring a philosophy of shareholder wealth maximization turns out—on closer examination—to have been about a squabble between two competitors where the stakes were consumer prices, product choice, employee wages, industry competition, and political pluralism.

"Other Constituency" Statutes

Some states have recently enacted "other constituency" statutes that permit, but do not require, directors to consider nonshareholder constituents (or stakeholders), particularly in the context of a corporate takeover. See Pa. BCL §1715 (directors may consider "shareholders, employees, suppliers, customers and creditors of the corporation … communities in which offices or other establishments of the corporation are located … short-term and long-term interests of the corporation"). The statutes have been controversial. Some commentators have praised them as signaling a new era of corporate social responsibility; others have criticized them as a ruse for incumbent entrenchment and fecklessness. By permitting directors to rationalize corporate decisions on such open-ended concepts as "long-term interests" and "communities where the corporation operates," the statutes appear to dilute director accountability.

Although no cases have confronted the meaning of the "other constituency" statutes, other cases give mixed signals about directorial deference to nonshareholder stakeholders. Some cases suggest directors can take stakeholders into account only if rationally related to promoting

shareholder interests. See *Revlon v. MacAndrews & Forbes Holding*, 506 A.2d 173 (Del. 1986). Yet others suggest directors have significant latitude to consider "corporate culture," not just immediate shareholder returns, when responding to takeover threats. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1142 (Del. 1990).

Corporate Social Responsibility (CSR)

Over the past decade, many companies have recognized that their responsibilities extend beyond the legal duties toward shareholders and others with whom the company does business. Although not required by law, many companies (particular multinational companies) have voluntarily taken responsibility for their impact on customers, workers, communities, and other stakeholders, as well as the environment.

Companies tout their CSR activities—such as "green" initiatives or "fair labor" commitments—to bolster their reputations as corporate citizens. To show their commitment to CSR, many companies have agreed to reporting guidelines and operational standards developed by various nongovernmental organizations (NGOs). In addition, some institutional investors seek to take into account in their investment and voting decisions whether companies have implemented CSR programs.

Proponents see CSR as "applied business ethics" and a means more suited than regulatory compliance for companies and their decision-makers to internalize externalities (the costs imposed by business on others). Critics claim that CSR is superficial window dressing that companies use to divert attention from the harms they cause and to forestall government regulation.

Recently, the CSR movement has received support from various quarters. In a nod to the growing relevance to investors of environmental concerns, the SEC has issued interpretive guidance to reporting companies on their disclosure regarding climate change. Guidance on Climate Change Disclosure, Securities Act Rel. No. 9106 (2010) (pointing out the insurance industry lists climate change as the number one risk facing the industry). While not taking a stance on the climate change debate, the SEC pointed out that under existing disclosure requirements (such as management's discussion of future contingencies) companies may have to disclose material information about (1) the impact on the company's business of existing (and even pending) climate change laws; (2) the impact of international accords on climate change; (3) the actual or indirect consequences of climate change

trends (such as decreased demand for carbon-intensive products or higher demand for lower-emission products); and (4) actual and potential physical impacts of environmental changes to the company's business. As some have pointed out, "what gets measured gets managed."

Congress has also added its voice on CSR issues. In 2010 the Dodd-Frank Act mandated that the SEC adopt a rule requiring disclosures by companies whose products contain "conflict minerals," such as tin, tantalum, tungsten, and gold, mined in the war-torn Democratic Republic of Congo. Under the rule adopted by the SEC, companies that use such minerals are required to examine their products and processes, and investigate the sourcing of the materials they use. See Exchange Act Release No. 67,716 (2012). In 2014, the SEC rule was successfully challenged in court as a violation of companies' First Amendment rights. *National Association of Manufacturers v. SEC*, 748 F.3d 359 (D.C. Cir 2014). The court concluded that the rule's requirement that companies label their products as not "DRC conflict free" in SEC filings (and on company websites) unconstitutionally compelled speech. The court pointed to the SEC's failure to consider whether less restrictive means (besides product descriptions) could achieve the rule's intended purpose to prevent the commerce in minerals used to fund the Central African armed conflict. The court said a couple alternatives were "intuitive"—namely, that issuers could use their own language to describe their products or that the SEC could compile its own list of "conflict minerals" products based on information submitted by companies to the SEC. The court, however, upheld other aspects of the rule, including the "de minimis" exception making the rule applicable only to manufacturers the longer phase-in of the rule for smaller companies. Soon after the court ruling, the SEC stayed the part of the rule requiring the company statements held to violate the First Amendment, though the rest of the rule's investigation and disclosure requirements remained in force. Two SEC commissioners questioned the rule's effect, pointing out its unintended consequence of putting out of work one million legitimate Congolese miners when U.S. companies avoided the rule's disclosure mandates by simply stopping their purchases of minerals from the Congo.

In addition, nongovernmental organizations (such as Ceres) are organizing investor groups, environmental organizations, and other public interest groups to work with for-profit corporations to address sustainability challenges such as climate change, resource use, and water scarcity. Even as

governments have been paralyzed to act, many investors and businesses in the private sector are moving ahead on sustainability initiatives. They understand that environmental and social sustainability presents risks (and opportunities) for their business and that sustainability considerations must be a part of their core business strategies if they are to achieve a competitive advantage—including corporate governance, stakeholder engagement, corporate disclosure, and performance. Some studies bear this out, finding a relationship between company sustainability performance and financial performance.

In a similar vein, the United Nations has reconceptualized the modern corporation as being quasi-governmental, with responsibilities not only to comply with law but also to respect human rights. For example, the U.N. Human Rights Council has adopted a set of guiding principles for business (known as the Ruggie Principles, for the professor who drafted them) that are designed to ensure that companies do not violate human rights in the course of their operations and provide redress when they do. The guiding principles —which place companies in the position of "private states"—lay out specific steps that companies should take to make sure they respect human rights. For example, companies are called on to undertake a "human rights due diligence," which includes impact assessment, monitoring, community engagement, and a grievance mechanism, so people who have even minor complaints against a company have a place to go to have issues addressed. The assessment should cover not only potential for adverse human rights impacts of the company's activities but also the impacts of business partners. The guidelines call on companies to use leverage to prevent or mitigate human rights abuses by business partners or to end the business relationship.

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§11.2 FIDUCIARY DUTIES OF CARE AND LOYALTY

According to traditional fiduciary analysis, corporate managers owe two duties to the corporation: care and loyalty. Each duty describes standards for judicial review of corporate decision-making and fiduciary activities.

Note on Duty of Good Faith (and Obedience to Legal Norms)

Delaware courts have recently articulated a duty of "good faith" that applies when directors act *intentionally* to violate positive law, with a purpose other than the corporation's best interests, or with a conscious disregard for their duties to act. *Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (2006). The courts have said that the duty of good faith is breached when directors fail to consider the financial ramifications of an executive's contingent pay package, when directors fail to establish an oversight system to monitor the corporation's legal compliance, or when directors act as "stooges" for a controlling shareholder. The courts have explained the good faith duty as a subset of the duty of loyalty and, as such, a duty that cannot be exculpated. See Del. GCL §102(b)(7) (see §15.1).

Delaware corporate law, like that of other states, also anticipates that an aspect of the duty of good faith is that corporate directors will abide by legal norms. See *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049 (Del. Ch. 1996) (concluding that "bad faith" is presented where board approves transaction "known to constitute a violation of applicable positive law"); see also Official Comment to MBCA §8.31 (stating that "conduct involving knowingly illegal conduct that exposes the corporation to harm will constitute action not in good faith"). Thus, the duties of care and loyalty may sometimes not describe fully the corporate legal landscape. Even if disinterested directors having no personal financial stake in a transaction decided with full information and after careful deliberation that it would be in the best (financial) interests of the corporation to violate a particular legal norm, the decision would still be subject to review. In such cases, it would seem that neither the duty of care nor the duty of loyalty is breached: the directors were informed, deliberative, disinterested and seeking to benefit the corporation. Yet, there is a clear judicial consensus that decisions to knowingly violate the law are beyond the pale. See §12.3.1 (Illegality); §12.3.4 (Monitoring Illegality). It would seem that another directorial duty might be at work: a duty of obedience. Such a duty exists in non-profit corporations, and once was part of the triumvirate of fiduciary duties in for-profit corporations.

§11.2.1 Duty of Care

The duty of care addresses the attentiveness and prudence of managers in performing their decision-making and oversight functions. The famous “business judgment rule” presumes that directors (and officers) carry out their functions in good faith, after sufficient investigation, and for acceptable reasons. Unless this presumption is overcome, courts abstain from second-guessing well-meaning business decisions even when they are flops. This is a risk that shareholders take when they make a corporate investment. See Chapter 12.

To encourage directors to take business risks without fear of personal liability, corporate law protects well-meaning directors through exculpation provisions in the corporation’s articles (see §12.5), statutory and contractual indemnification (see §15.1), and directors’ and officers’ insurance (see §15.2).

§11.2.2 Duty of Loyalty

The duty of loyalty addresses fiduciaries’ conflicts of interest and requires fiduciaries to put the corporation’s interests ahead of their own—that is, fiduciaries cannot serve two masters. Corporate fiduciaries breach their duty of loyalty when they divert corporate assets, business opportunities, or proprietary information for personal gain.

Flagrant Diversion

Diversion can be as simple, and as reprehensible, as a corporate official stealing tangible corporate assets. This is a plain breach of the fiduciary’s duty of loyalty because the diversion was unauthorized and the corporation received no benefit in the transaction. Besides disaffirming the transaction as unauthorized (see §3.3.3), the corporation can sue for breach of fiduciary duty and in tort.

Self-Dealing

Diversion can be masked in a self-dealing transaction. When a fiduciary enters into a transaction with the corporation on unfair terms, the effect (from the corporation’s standpoint) is the same as if he had appropriated the

difference between the transaction's fair value and the transaction's price. Courts, as well as statutes, address the issue when a self-dealing transaction is unfair. See Chapter 13.

A parent corporation that controls a partially-owned subsidiary can breach its duty to the minority shareholders of the subsidiary if the parent prefers itself at the expense of the minority. See §17.2. The ultimate form of preferential dealing occurs when the parent squeezes out the minority (in a merger or other transaction) and forces the minority to accept unfair consideration for their shares. See §17.3.

Executive Compensation

When a director or officer sells his executive services to the corporation, diversion can occur if the executive's compensation exceeds the fair value of his services. See Chapter 14.

Usurping Corporate Opportunity

When a corporate fiduciary seizes for herself a desirable business opportunity that the corporation may have taken and profited from, diversion occurs if the fiduciary denies the corporation the opportunity to expand profitably. See Chapter 16.

Disclosure to Shareholders

Corporate officials who provide shareholders false or deceptive information, on which the shareholders rely to their detriment, not only undermine corporate credibility and transparency, but frustrate shareholders' expectations of fiduciary honesty and accountability. Duties of disclosure arise when directors seek a shareholder vote (see Chapter 8—state law; Chapter 10—federal proxy fraud) and when corporate officials communicate to stock trading markets (see §21.1—state law; Chapter 22—federal Rule 10b-5).

Trading on Inside Information

When a fiduciary is aware of confidential corporate information—such as the impending takeover of another company—and he buys the target's stock, diversion can occur if the fiduciary's trading interferes with the corporation's takeover plans. By the same logic, when the fiduciary trades with the

company's shareholders using inside information, the fiduciary diverts to himself information belonging to the corporation. See Chapter 23.

Selling Out

A corporate official who accepts a bribe to sell her corporate office breaches a duty to the corporation. Likewise, a controlling shareholder who sells his controlling interest to a new owner who then diverts corporate assets to herself exposes the remaining shareholders to the new owner's looting. See §20.2.

Entrenchment

A manager who uses the corporate governance machinery to protect his incumbency effectively diverts control from the shareholders to himself. Besides preventing shareholders from exercising their control rights—whether by voting or selling to a new owner—management entrenchment undermines the disciplining effect on management of a robust market in corporate control. See Chapter 8 (voting manipulation); §39.2 (takeover defenses).

There is no uniform standard for judging these conflict-of-interest transactions. Some are flatly prohibited (insider trading), others receive searching judicial fairness review (squeezeouts), and others are subject to internal corporate safeguards (executive compensation).

§11.2.3 Judicial Enforcement of Fiduciary Duties

Fiduciary duties generally are said to be owed to the corporation and not to particular shareholders and must be enforced in the name of the corporation. This reflects the practical and conceptual danger of one shareholder purporting to speak for the body of shareholders. Rarely, however, are fiduciary breaches challenged by the corporation because those who abused their control are unlikely to sue themselves. Instead, fiduciary breaches usually are challenged by shareholders in derivative litigation brought on behalf of the corporation (see Chapter 18).

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§11.3 FIDUCIARY DUTIES—CORPORATE

AND MARKET REALITIES

§11.3.1 Fiduciary Duties in Closely Held Corporations

In closely held corporations (those that do not have a trading market for their shares) the corporate participants often have a relationship of special trust. No market exists for their shares. Some courts have implied a duty among participants akin to that of partners. Other courts have used statutory protections against "oppression" to intervene on behalf of minority shareholders. See Chapter 27.

A frequent issue in close corporations is whether fiduciary duties can be modified by agreement. Although modern partnership law permits partners to waive fiduciary rights, courts have been less willing to see corporate fiduciary duties as default terms. Compare RUPA §103(b) (permitting partners to waive duty of loyalty as to categories of activities, if not manifestly unreasonable, and to reduce duty of care if not unreasonable). Rather, corporate fiduciary duties have been viewed as immutable aspects of the corporate relationship.

§11.3.2 Fiduciary Duties in Modern Public Corporations

In public corporations, management has three principal functions. First, directors and senior executives make "enterprise" decisions concerning operational and business matters—such as where to locate a new facility or whether to discontinue a product line. The board establishes the strategic plan; senior executives carry it out. Directors rely on the senior executives for information in establishing and monitoring the business plan. Shareholder and management interests typically overlap as to these enterprise decisions, as reflected in the deferential business judgment rule.

Second, directors act on "ownership" issues—such as initiating a merger with another company or constructing takeover defenses. Outside directors (that is, directors who are not employed by the corporation) have assumed special prominence on these issues, as courts often defer to the independent judgment of outside directors when corporate control is at stake. Although

directors in public corporations once were criticized for acting as "rubber stamps" for management, directors lately have become more forceful. Spurred by activist institutional investors and the clamor after Sarbanes-Oxley, outside directors have asserted themselves by replacing CEOs, negotiating takeovers, and making themselves more accountable. Outside directors, sometimes acting in special committees, often turn to their own legal and investment advisors.

Third, directors are responsible for "oversight" of the corporation—such as reviewing senior executives' performance and ensuring corporate compliance with legal norms. In public corporations the board often establishes compliance programs and receives regular management reports. As corporate responsibility has grown in such areas as regulatory compliance and foreign bribery, courts have increasingly insisted on higher levels of board oversight. In addition, disclosure by the company to public trading markets allows shareholders to gauge how well management is overseeing the corporation.

Management in public corporations lives under the watchful eye of the securities markets. When the market detects mismanagement, the trading price of the company's stock falls. This makes it attractive for outside bidders or shareholder insurgents to acquire control and oust the ineffective management. In extreme cases, a collapse in the stock price signals to creditors that the company is insolvent and should be put in the hands of a bankruptcy court. Fiduciary norms take these corrective mechanisms into account, relaxing scrutiny when control markets are available to discipline poor management and tightening scrutiny when the board attempts to insulate itself from these markets.

Note on "Imperial CEO"

In the United States *corporate management* in public corporations often refers to the Chief Executive Officer (CEO), whose vision and leadership make him or her the ultimate manager of the company. In most companies, investors focus on outside directors only when something goes wrong. The CEO puts together a management team—including a Chief Operating Officer (COO), Chief Financial Officer (CFO), and Chief Legal Officer (CLO or General Counsel)—to oversee

and run the company's business. Generally, investors and employees look to the CEO as the symbol of ultimate authority for the company. This is not, of course, what the law says. But the reality is that outside directors, chosen through a nominating process often heavily influenced by the CEO, have few incentives to be suspicious or adversarial. They are mostly dependent on the CEO's management team for information and analysis. Strategy is typically developed by the management team in internal discussions and then presented to the board for approval.

§11.4 INDEPENDENT DIRECTORS

Over the last several years, directors who do not have an employment relationship with the corporation—so-called independent directors—have assumed increased prominence in U.S. public corporations. The accounting and financial scandals that came to light in the early 2000s focused attention on the failures of outside directors to monitor and oversee corporate management. Paradoxically, the response has been to assign even greater importance to independent directors. Empirical studies are mixed on whether outside directors increase company profitability and whether they have an effect on controlling management excesses.

Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002 (described in §11.5.1) specifies the responsibilities of independent directors on the audit committees of public corporations. As required by Sarbanes-Oxley, stock exchanges have adopted listing standards that specify the composition and functions of the audit committees of listed companies (including foreign issuers and small business issuers). Under these standards, audit committees must be composed entirely of independent directors, as defined by the SEC.

In addition, all reporting companies must disclose whether at least one member of the audit committee is a financial expert. Sarbanes-Oxley §407, Reg. S-K, Item 401 (defining "audit committee financial expert" as one with significant auditing, accounting, financial, or comparable experience).

In addition, the exchanges' governance listing standards must also specify that the audit committee of listed companies be responsible for appointing,

compensating, and overseeing the company's independent audit firm—a curtailment of the power of the full board and shareholders over outside accountants. The audit committee (not the board) must have the authority to hire independent counsel and other advisors, their fees to be paid by the listed company. Rule 10A-3; Exchange Act Rel. No. 47,654 (2003).

Dodd-Frank

The Dodd-Frank Act of 2010 (described in §11.5.2) also intrudes into the boardroom of public corporations, requiring the stock exchanges to adopt listing standards that require all the directors on the corporation's compensation committee to be independent. Dodd-Frank §952. The committee must also have the authority to hire independent compensation consultants.

Delaware

State courts, particularly in Delaware, have increasingly deferred to independent directors in various contexts. Delaware courts review deferentially corporate transactions in which management has a conflicting interest if a majority of the board is composed of directors who are *disinterested* (no conflicting financial interest in the transaction) and *independent* (neither beholden to interested party because of financial or business relationships, nor dominated by interested party through family or social relationships). See *Orman v. Cullman*, 794 A.2d 5 (Del. Ch. 2002) (distinguishing between "interest" and "independence" of directors).

Delaware courts focus on director independence in deciding whether

- to shift the burden to the challenging shareholder in transactions involving management conflicts. See §13.3.3 (director self-dealing transactions), §17.3.3 (squeeze-out mergers).
- to review executive pay under a waste standard, rather than the more burdensome fairness standard. See §14.2.3 (executive compensation).
- to indemnify corporate officials who become liable or settle claims arising from their corporate position. See §15.1.2 (permissive indemnification).
- to approve settlement of derivative litigation. See *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991) (approving settlement of claim that company had

wasted corporate assets in donating money for art museum to house CEO's personal art collection).

- to dismiss shareholder derivative litigation, either on the basis of "demand futility" or recommendations of a special litigation committee. See §18.5.3 (demand requirement), §18.5.4 (special litigation committee).
- to uphold antitakeover measures (whether in anticipation of unwanted bids or in response to particular threats) and deal protection measures. See §8.2.2 (shark repellents), §39.2.3 (takeover defenses), §39.2.4 (deal protections).

Delaware courts have recently shown more willingness to inquire into the social and business relationships between outside directors and management—to test whether there exists implicit directorial bias. For example, the Delaware Chancery Court questioned the independence of a tenured Stanford law professor, who as a member of a special litigation committee was asked to determine whether suit should be brought against various corporate executives who allegedly had engaged in insider trading. The court concluded the professor's and executives' close and overlapping ties to Stanford—as large donors, fellow professors, and members of a university policy institute—suggested an institutional context in which motives of "friendship and collegiality" could not be ignored. *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003). But the Delaware Supreme Court has stopped short of saying that social and business relationships alone undermine independence. See *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004) (finding directors sufficiently "independent" in demand-futility case, despite longstanding personal friendships and close business relationships to CEO, who held 94 percent of the company's voting power).

The MBCA goes one step further and makes lack of independence a basis for imposing liability on directors in an interested-party transaction. See MBCA §8.31(a)(2)(iii) (making director liable if director's judgment is affected because of a lack of objectivity due to director's familial, financial, or business relationship with interested person or a lack of independence due to director's domination or control by interested person). Upon such a showing, the director has the burden to prove that he reasonably believed the challenged conduct was in the best interests of the corporation. MBCA §8.31(a)(2)(iii)(B).

Corporate Governance in Stock Listing Standards

The New York Stock Exchange and the NASDAQ have adopted standards that compel listed companies to adopt corporate governance structures that emphasize "independent directors." In many instances, these listing standards are mandated by Sarbanes-Oxley and Dodd-Frank:

Governance Listing Standards (NYSE and NASDAQ)	
Independence of majority of directors	• Majority of directors must be "independent" and not have "material relationship" with company (NYSE only) • Majority of directors must be "independent" (NASDAQ only) • Determination of director qualifications disclosed in proxy statement (or annual report if company not subject to proxy rules)
"Independence" defined	Director not "independent" if • director is company employee or director's family member is company executive • director (or family member) receives payment from company (NYSE — more than $100,000; NASDAQ — more than $60,000) • director (or family member) affiliated with current or past auditor • company executives sit on compensation committee of outside director's company • company has significant dealings with outside director's company (NYSE — $1,000,000 or 2 percent of outside company's revenues; NASDAQ — $200,000 or 5 percent of outside company's revenues)

Governance Listing Standards (NYSE and NASDAQ)	
Executive sessions	• Independent directors must meet at regularly scheduled meetings without management • Company must have method for internal and shareholder communications to independent directors (NYSE only)
Committees	• **Audit committee** must be comprised solely of three or more independent directors who are "financially literate"; members must meet SEC standards on independence; at least one member must meet SEC "financial expert" standard • **Nominating committee** must be composed solely of three or more independent directors (with limited exception for one outside, nonindependent director); company must certify adoption of nomination process • **Compensation committee** must be composed only of independent directors (as defined by SEC rule) with exclusive power to hire independent compensation consultants
Code of conduct	• Company must adopt and disclose code of conduct that meets requirements of Sarbanes-Oxley • Any waivers for directors and officers must be approved by board and disclosed on Form 8-K
Corporate governance guidelines	• Company must adopt and disclose guidelines on director qualifications, compensation, education, responsibilities, succession, annual evaluation, access to management (NYSE only)
Audits	• Company must have internal audit function, cannot be outsourced to company's outside auditor (NYSE only) • Company must disclose receipt of audit opinion with "going concern" qualification (NASDAQ only)
Related party transaction	• Audit committee, or group of independent directors, must approve related party transactions (NASDAQ only)
Certification	• CEO must certify annually that company is in compliance with governance listing standards (NYSE only) • Company must notify NYSE or NASDAQ if company executives become aware of material noncompliance
Exceptions	• Independent director requirements not applicable to companies controlled 50 percent or more by individual, group, or another company • Investment companies generally not subject to governance listing standards • Foreign issuers listed on NYSE not subject to governance listing standards, except SEC standards on audit committee independence • Foreign issuers listed on NASDAQ may apply for exemptions from governance listing standards, except SEC standards on audit committee independence

§11.5 FEDERALIZATION OF CORPORATE GOVERNANCE

Although corporate fiduciary duties arise mostly under state law, federal law has come to play an important role in corporate governance of public corporations. Since the 1930s, federal securities regulation has imposed disclosure requirements that compel corporate fiduciaries in public corporations to reveal information about the operational and financial details of the business as well as the roles of the fiduciaries in the corporation. Thus,

corporate fiduciaries in public companies must disclose information to new public shareholders (see Chapter 5) when shareholders vote (see Chapter 9) and when shareholders tender their shares (see Chapter 38). Corporate fiduciaries also face restrictions on their ability to trade in company shares while in the possession of nonpublic material information (see Chapter 23). But, with rare exceptions, the federal regulatory scheme has been premised on disclosure to shareholders.

Recently, federal law has expanded beyond requiring corporate disclosures. The corporate scandals of the early 2000s and the financial crisis of 2008 have caused Congress to rethink the place of federal law in corporate governance of public corporations. In 2002 Congress responded to the misdeeds at companies like Enron and WorldCom by enacting the Sarbanes-Oxley Act, which revamped the regulation of the accounting profession and imposed a variety of new rules on the boards of directors and officers of public companies. In 2010 Congress responded to the financial crisis in the banking sector by enacting the Dodd-Frank Act, not only to reregulate the financial markets but also to add new rules on corporate governance and executive compensation in all public companies.

Note on Securities Regulation

In keeping with the traditional demarcation of corporate law and securities regulation in the United States, this book considers the aspects of Sarbanes-Oxley that deal with corporate governance. Those reforms that address disclosure to investors—securities regulation—are left to other sources. See Alan R. Palmiter, *Securities Regulation: Examples & Explanations* (6th ed. Wolters Kluwer Law & Business 2014).

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§11.5.1 Sarbanes-Oxley Act of 2002

Responding to the accounting and corporate scandals of the early 2000s, Congress passed sweeping legislation that departs in many instances from the disclosure-based philosophy of the federal securities laws. The Public Company Accounting Reform and Investor Protection Act of 2002 (known as the Sarbanes-Oxley Act, after its congressional sponsors) seeks both to strengthen the integrity of the federal securities disclosure system and to

federalize specific aspects of public corporation law.

Story of Enron

The story of Enron's rise and fall is an inextricable part of Sarbanes-Oxley. An energy trading company that started as a stodgy natural gas pipeline, Enron grew dramatically during the 1990s to become the seventh-largest corporation in the United States by market capitalization. Its innovative business model, widely lauded and studied, involved the creation of a freewheeling trading market in wholesale energy and transmission (with appurtenant risk management and financial hedging products).

At first the new market and Enron thrived. But as competitors imitated its model, Enron had to look for new ways to maintain its constantly growing profits. Its executives devised two main techniques: (1) Enron entered into paper transactions with special-purpose entities that created the appearance of revenues on Enron's financial statements, and (2) Enron financed these related entities with loans (secured by its high-priced stock) that were not reported as debt on Enron's balance sheet. In short, Enron began trading with itself and placing bets on its common stock.

Both the related-entity transactions (in which high-placed Enron executives held personal investments) and their accounting treatment received the blessing of the Enron board of directors, its auditing firm Arthur Andersen, and its outside law firm Vinson & Elkins. Also, securities firms that participated in financing Enron's related entities pressured their securities analysts to recommend the company's stock. Rather than question anomalies in its financial statements, the investment community awarded Enron with accolades and an ever-increasing stock price.

In 2001 Enron's stock price began to slip as investors became suspicious of its related-entity dealings. As federal investigators began their probes, Enron's auditor publicly vouched for the company's financial statements, while privately shredding incriminating documents. In late 2001, Enron restated its financials for the previous four years and, with a few pencil strokes, reduced its net income by $600 million and increased its debt by $628 million. Bankruptcy soon followed.

Although many in the financial (and political) community decried Enron as a "bad apple," the true impetus for legislative reform came from the almost weekly revelations in late 2001 and early 2002 of new financial scandals at other companies. Some had reported not actual earnings but predicted *pro*

forma earnings. Some had treated payments for phone capacity as an investment, not a current expense—thus overstating both assets and net earnings. Some had engaged in paper buy-sell transactions to report immediate revenues while amortizing costs. The final straw came when WorldCom, the second-largest U.S. telecommunications company and operator of MCI, announced that $7 billion the company had reported as assets should have been treated as operating costs. Within weeks the company declared bankruptcy, and a few weeks later Congress passed Sarbanes-Oxley.

Pavlovian Response to Enron

Sarbanes-Oxley reads like a Pavlovian response to the stories of business and financial misconduct revealed in congressional hearings into the collapses at Enron, WorldCom, and a slew of other companies—most in the overbuilt telecom industry. Consider the list of corporate misconduct revealed to Congress and the regulatory responses in Sarbanes-Oxley:

Misconduct	Sarbanes-Oxley Response
Outside auditors failed to discover or report accounting fraud. Some attributed this failure to self-regulation of the accounting profession, which during the 1990s relied on technicalities to satisfy clients. In particular, the accounting firm Arthur Andersen (auditor for many scandal-ridden companies) was passive toward financial irregularities at many clients.	• **PCAOB.** Creates a self-regulatory, five-person Public Company Accounting Oversight Board to establish auditing standards and regulate accounting profession (Sarbanes-Oxley §101) • **Auditor registration.** Requires accounting firms that audit public companies to register with PCAOB (Sarbanes-Oxley §102) • **Audit standards.** Authorizes PCAOB to set standards for public company audits and to enforce its audit rules (Sarbanes-Oxley §§103, 104, 105) • **Auditor sanctions.** Authorizes SEC to sanction auditors for intentional, reckless, and highly negligent conduct (Sarbanes-Oxley §602)
Outside auditors performed nonaudit services that undermined their audit independence. For example, Arthur Andersen came to earn more from Enron for its nonaudit services than for its work as financial auditor.	• **Nonaudit services.** Bans auditors from providing certain types of nonaudit services and requires preapproval by the company's audit committee of permissible nonaudit services (Sarbanes-Oxley §§201, 202)
Outside auditors became too "cozy" with executives of audit clients. For example, many financial officers of Enron were former principals of Arthur Andersen, its auditor.	• **Auditor rotation.** Requires rotation of audit partner every five years (Sarbanes-Oxley §203) • **Revolving door.** Closes "revolving door" for members of audit team who within one year after engagement become financial/accounting officers of audit client (Sarbanes-Oxley §206)

Misconduct	Sarbanes-Oxley Response
Corporate boards (especially board audit committees) failed to supervise outside auditors and lacked expertise to understand the company's finances. The Enron board became a symbol of directorial inattention.	• **Audit committee composition.** Authorizes SEC to have stock exchanges change their listing requirements to require audit committees composed only of independent directors, with full authority over outside auditor (Sarbanes-Oxley §301 — see §11.4) • **Financial expert.** Requires disclosure whether company has at least one "financial expert" on audit committee (Sarbanes-Oxley §407 — see §12.3.5)
Corporate executives failed to ascertain the truthfulness of company filings and to supervise subordinates and pressured auditors to give "clean" reports.	• **Officer certification.** Requires SEC rules that CEO and CFO certify that SEC filings are true, complete, and fairly presented (Sarbanes-Oxley §302 — see §21.2.2) • **Internal controls.** Requires SEC rules on disclosure of internal controls, and requires top executives to certify them (Sarbanes-Oxley §404 — see §12.3.5) • **Auditor influence.** Prohibits company officials from improperly influencing outside auditors (Sarbanes-Oxley §303)
Companies failed to report (and the SEC failed to notice) their true financial condition, especially the potential effect of risky off-balance sheet arrangements.	• **Real-time disclosures.** Requires companies to make additional, real-time disclosures in "plain English" of current changes to financial condition (Sarbanes-Oxley §409 — see §21.2.2) • **Off-balance sheet transactions.** Mandates SEC rules requiring disclosure of all material off-balance sheet arrangements (Sarbanes-Oxley §401) • **SEC review.** Requires SEC to review filings by reporting companies at least every three years (Sarbanes-Oxley §408)
Corporate cultures encouraged irresponsible behavior, such as unauthorized or excessive loans to company executives. For example, at Adelphia the family of the company founder received $3.1 billion in loans and other benefits while the company was reporting large financial losses.	• **Code of ethics.** Requires disclosure whether the company has a code of ethics applicable to senior financial officers or justify why not (Sarbanes-Oxley §406 — see §12.3.5) • **Director and officer bans.** Authorizes SEC to remove "unfit" officers and directors from their positions and bar them from similar offices in other public companies (Sarbanes-Oxley §§305, 1105) • **Personal loans.** Forbids "personal loans" to company directors and officers, except in regular course of company's lending business (Sarbanes-Oxley §402–§14.4.2) *(continued)*

Misconduct	Sarbanes-Oxley Response
Corporate executives sold company stock while aware of accounting misinformation and while employees in the company's pension plan could not sell.	• **Clawbacks.** Requires forfeiture of executive pay and trading gains when company restates financials due to misconduct (Sarbanes-Oxley §304 — see §§14.4.2, 23.4.2) • **Blackout periods.** Bars company executives from selling stock during any trading blackout period imposed on employees (Sarbanes-Oxley §306 — see §23.4.1) • **Insider reports.** Requires corporate insiders to disclose their trading in company stock within two business days (Sarbanes-Oxley §403 — see §24.2)
Outside securities lawyers "papered" illegal transactions or failed to intercede to stop company wrongdoing.	• **Up-the-ladder reporting.** Mandates SEC rules requiring lawyers working for public company to report securities violations and fiduciary breaches up the internal corporate ladder (Sarbanes-Oxley §307 — see §12.3.5) • **Lawyer malpractice.** Authorizes SEC to bring enforcement actions against lawyers for malpractice (Sarbanes-Oxley §602)
Securities analysts prepared biased research reports for companies with whom their securities firms did business.	• **Analyst reports.** Mandates SEC to adopt rules on the independence and objectivity of securities analysts and protect them from retaliation for negative reports or ratings (Sarbanes-Oxley §501)
Many frauds only came to light because of courageous "whistle-blowers" inside the company.	• **Whistleblower protection.** Imposes criminal liability on those who retaliate against employees (whistleblowers) who provide evidence or assist in the investigation of business crimes (Sarbanes-Oxley §1107 — see §12.3.5) • **Whistleblower action.** Creates an administrative redress for whistleblowers who experience retaliation to seek compensatory damages, reinstatement, back pay, litigation costs (Sarbanes-Oxley §806 — see §12.3.5) • **Hotlines.** Requires audit committees to create procedures for handling (anonymous) complaints about accounting improprieties (Sarbanes-Oxley §301 — see §12.3.5) • **Statute of limitations.** Extends statute of limitations in cases of securities fraud to two years from discovery or five years from violation (Sarbanes-Oxley §804 — see §22.4.1)

Misconduct	Sarbanes-Oxley Response
Company officials and outside auditors destroyed documents to cover up wrongdoing. For example, Arthur Andersen employees destroyed Enron documents, hoping to hide the financial scandal.	• **Criminal sanctions.** Increases criminal sentences for destruction, alteration, or falsification of records in federal investigation and for violating rules on document retention (Sarbanes-Oxley §802) • **Obstruction crime.** Creates a new crime for obstructing a proceeding, including tampering with documents (Sarbanes-Oxley §1102)
Company officials did not take their oversight and disclosure responsibilities seriously.	• **Heavier sentences.** Increases criminal sentences for corporate officials who retaliate against whistleblowers, those who commit mail and wire fraud, and those who falsely certify financials (Sarbanes-Oxley §§806, 903, 906, 1107) • **New crime.** Creates a new crime of "knowing securities fraud," with maximum prison term of 25 years (Sarbanes-Oxley §807)

Disclosure versus Corporate Governance

Many of the congressional responses in Sarbanes-Oxley sought to strengthen disclosure—the heart of federal securities regulation. For example, the rules affecting auditors sought to revitalize auditor independence; the requirements for audit committees and certifications of SEC filings by company executives sought to focus corporate attention on proper disclosure; the requirements on internal controls, the encouragement of whistleblowers, and the "up-the-ladder" reporting by securities lawyers sought to deter and detect securities fraud. In each case, the ultimate goal was to improve the integrity of the disclosure system and to lower the risk of fraud.

Other congressional responses, however, ventured into waters previously uncharted by federal securities law. By specifying board functions and regulating specified corporate transactions, Sarbanes-Oxley moved into areas of corporate governance historically within the domain of state corporate law. For example, the provisions that specify the composition and responsibilities of board audit committees, the restrictions on loans to corporate executives, the forfeiture of executive pay after financial restatements, and limitations on trading by executives during blackout periods have traditionally been subjects of state corporate statutes and fiduciary law. The reforms aimed to reshape

the corporate culture of public corporations.

Evaluation of Sarbanes-Oxley

How effective have the new accounting, internal controls, ethics codes, and compliance structures called for by Sarbanes-Oxley been? Many businesses, particularly smaller public companies, complained that the heavy compliance costs of the Act were not worth the marginal benefits. (And the Dodd-Frank Act codified the SEC approach to exempt small public companies from the Sarbanes-Oxley §404 requirement that an auditor attest to the company's internal controls. See Dodd-Frank §989G.) Others have commented on how Sarbanes-Oxley changed attitudes toward corporate governance, with both insiders and outside gatekeepers in public corporations more sensitive to their responsibilities.

Some public companies claimed that the costs of remaining public were too high after Sarbanes-Oxley and "went private" by using private capital to buy their public shares. The companies said that the costs of internal controls and other corporate governance mechanisms required by Sarbanes-Oxley made private financing less expensive than public financing. Nonetheless, many (if not most) of these companies continued to be subject to the reporting requirements of the federal securities laws (including Sarbanes-Oxley) when they issued publicly traded debt to repurchase their public equity. The claims about the excessive regulatory costs of Sarbanes-Oxley may have been political grandstanding.

Academic commentators have also debated the merits of the legislation. Some see it as part of the centuries-old cycle of capital market booms and busts, inevitably followed by a frenzy of regulation—in this case, perhaps unnecessary, ill-conceived, or even counterproductive. Others assert that except for the creation of a new regulatory structure for the accounting profession the legislation merely codified reforms already underway by the stock exchanges, the SEC, sentencing authorities, and state judges. Yet even if Sarbanes-Oxley was superfluous, some have found value in its signaling of the government's resolve to address improper corporate behavior.

Empirical studies indicate that investors have responded favorably to some of the Sarbanes-Oxley initiatives. According to one study, investors have shown greater confidence in the information contained in SEC filings certified by company officers (as mandated by Sarbanes-Oxley) compared to prior uncertified filings. Another study finds that questionable "management"

of accounting earnings, which increased steadily from 1987 to 2001, decreased after the enactment of Sarbanes-Oxley, with a resulting greater reliance by investors on reported earnings. Most remarkable was the steady rise after the Act's enactment in corporate restatements of financial results, as corporate managers and accountants sought to correct errors large and small. More recently, corporate financial restatements by public companies (particularly larger companies) have been on the decline, suggesting that the audit function and internal controls may be working.

§11.5.2 Dodd-Frank Act of 2010

In the fall of 2008, the U.S. financial markets nearly collapsed. Banks stopped lending, investors dumped their securities, and the U.S. economy stumbled badly. The reasons for the collapse are still being debated, but the most popular culprit has been the "housing bubble" of the 2000s. Trillions of dollars went to finance unsustainable (subprime) mortgage loans, many of which ended up in the portfolios of the leading financial institutions in this country and abroad.

In response, Congress enacted the Wall Street Reform and Consumer Protection Act (known as the Dodd-Frank Act, after its principal congressional sponsors) to reform the U.S. financial system. Most of Dodd-Frank's reform agenda was focused on the systemic risks in the financial system, the stability of financial institutions, and the investment and lending practices of U.S. banks. But Dodd-Frank also took aim at corporate governance in public corporations—primarily by expanding the voting rights of shareholders and increasing the responsibilities in public companies regarding executive compensation.

Dodd-Frank is a massive piece of legislation, running 2,300 pages in length with 240 rulemaking directives to the SEC and other regulatory agencies (some of them new agencies) and 89 additional directives to these agencies to issue reports and conduct studies. Under Dodd-Frank, the SEC alone must adopt 95 new rules and prepare 22 reports—by comparison, Sarbanes-Oxley required only 14 new rules and 1 study by the SEC. The success of Dodd-Frank, as you can see, will depend on how the regulators carry out these directives.

Corporate Governance Reforms

Some of the corporate governance reforms introduced by Dodd-Frank sought to invigorate shareholder voting in public companies (eliminate broker voting and allow shareholders to nominate directors); others sought to foster further board independence (disclosure about separating chair and CEO positions and mandating independent directors on the board's compensation committee); and others sought to fine-tune the Sarbanes-Oxley reforms (exemption of small companies from internal controls and additional protection of whistleblowers). The Dodd-Frank corporate governance agenda, however, focused most of its attention on executive compensation in public corporations (expand disclosure, require independent compensation committees, mandate shareholder advisory votes on executive pay and golden parachutes).

Here is an overview of the Dodd-Frank corporate governance and executive compensation reforms, along with a notation of the status of their implementation as of the end of 2011:

Corporate Governance Reforms	
Shareholder voting reforms	• **Broker votes.** Requires national stock exchanges to prohibit voting by nonbeneficial owners (brokers), unless they have been specifically instructed to do so by the beneficial owner (Dodd-Frank §957 amending Exchange Act §6(b) — see §6.2.1) [partially implemented as of 2011] • **Proxy access.** Authorizes the SEC to issue rules that would specify the conditions for shareholders in public companies to access the company's proxy materials to nominate directors to the board (Dodd-Frank §971, amending Exchange Act §14(a) — see §9.4.3) [SEC rule withdrawn]
Oversight within corporation	• **Disclosure CEO/chairman role.** Mandates that the SEC adopt rules requiring public companies to disclose whether the CEO and board chair are the same person and, if so, the reasons for doing so (Dodd-Frank §972 — see §9.4.2) [no proposed rules as of 2011] • **Internal controls exemption**. Exempts small business issuers (public companies with less than $75 million in market capitalization) from the Sarbanes-Oxley §404 requirement that an auditor attest to their internal financial controls and calls for the SEC to study how to reduce the compliance burden on companies with a market capitalizations of $75–$250 million (Dodd-Frank §989G — see §12.3.5) [fully implemented as of 2011]
Whistleblower protection	• **Increased protections.** Strengthens private action for whistleblowers against employers who retaliate against them, including remedies for reinstatement and double back pay (Dodd-Frank §924, amending Exchange Act 21F-1 — see §12.3.5) • **Increased bounties**. Mandates new SEC program under which employees and others who report securities violations in a company can be rewarded between 10 and 30 percent of the funds recovered based on the information provided (Dodd-Frank §§922–924, amending Exchange Act 21F — see §12.3.5) [fully implemented as of 2011]
Executive Compensation Reforms	
Additional compensation disclosure	• **Pay for performance.** Mandates SEC rules requiring additional disclosure and charts comparing executive pay to stock performance over a five-year period (Dodd-Frank §953 — see §14.4.4) • **Pay gap.** Mandates SEC rules comparing CEO pay and median pay of all of the company's employees (Dodd-Frank §953 — see §14.4.4)

Executive Compensation Reforms	
Internal governance reforms	• **Compensation committee independence.** Mandates that exchange listing standards require compensation committees of public companies be composed only of independent directors with the authority to hire independent compensation consultants (Dodd-Frank §952 — see §30.1.3) [rulemaking underway as of 2011] • **Clawback policy.** Mandates that stock exchange listing standards require that companies have (and disclose) a policy that, whenever the company restates its financials because of misconduct, CEOs and CFOs must reimburse the company for any bonuses and other stock-based incentive compensation they received; provides that the SEC can bring an enforcement action to enforce this "clawback" obligation (Dodd-Frank §954 — see §14.4.3) [not yet implemented as of 2011]
Increased shareholder role	• **"Say on pay."** Mandates nonbinding shareholder vote on the pay package given the company's top executives, as well as nonbinding shareholder vote on whether the "say on pay" vote will occur every one, two, or three years (Dodd-Frank §951(a), adding Exchange Act §14A(a) — see §14.4.4) [fully implemented as of 2011] • **"Say on golden parachutes."** Mandates nonbinding shareholder vote on compensation that executives receive in mergers and other extraordinary business transactions and requires disclosure on such compensation (Dodd-Frank §951(b), adding Exchange Act §14A(b) — see §14.4.4) [fully implemented as of 2011] • **Institutional reports of voting.** Requires institutional investors, such as pension funds and hedge funds, with more than $100 million under management to report annually their "say on pay" and "say on golden parachute" votes (Dodd-Frank §951(a), adding Exchange Act §14A(d) — see §14.4.4) [proposed rulemaking as of 2011]

As you can see, Dodd-Frank imposes significant regulatory requirements on public companies that intrude into areas once reserved for state law and company-by-company implementation. Some provisions, such as the creation of "clawback" policies, continue regulatory requirements first imposed by Sarbanes-Oxley. Others, such as shareholder voting on executive pay and nomination of directors through the company's proxy, are federal innovations. One of the more interesting aspects of these corporate governance reforms is that many of them came, for the first time, in response to the clamor of institutional investors, primarily activist pension funds.

Securities Regulation Reforms

The financial regulatory reforms of Dodd-Frank include many that affect traditional securities regulation. Some of the reforms create new regulation for financial intermediaries that had been only lightly regulated before (such as credit rating agencies, hedge funds, and private equity funds). Other

reforms regulate new categories of financial instruments—such as credit-default swaps—forcing their trading on transparent exchanges.

Reflecting a concern that SEC regulation had been too lax, the agency received new enforcement powers and directives to provide greater protection to investors in private markets. The relationship between broker-dealers and their customers came under scrutiny, with a call for the SEC to consider subjecting broker-dealers to the same fiduciary standards as investment advisers and limiting the scope of predispute arbitration agreements in broker-customer disputes.

Here is a list of the more prominent Dodd-Frank reforms of securities regulation:

Securities Regulation Reforms	
New regulation of financial intermediaries	• **Credit rating agencies.** Subjects credit rating agencies to new duties — and accompanying liabilities — similar to those of securities firms that participate in securities offerings (Dodd-Frank §§932–939) • **OTC derivatives.** Authorizes SEC regulation of OTC derivatives such as credit-default swaps (Dodd-Frank §701–774) • **Private funds.** Requires that advisers of "private funds" (defined to include hedge funds and private equity funds) register with the SEC (Dodd-Frank §§402, 403)
New SEC enforcement powers	• **Aiding and abetting.** Increases aiding and abetting enforcement powers for the SEC under various securities laws not previously covered (Dodd-Frank §§929M, 929N) • **Subpoena powers.** Grants broader (nationwide) subpoena authority to the SEC (Dodd-Frank §929E) • **Extraterritorial enforcement.** Grants SEC enforcement powers over extraterritorial securities fraud (Dodd-Frank §929P) • **Collateral bars**. Grants SEC authority to bar directors and officers committing (or aiding and abetting) securities fraud from holding office in public companies (Dodd-Frank §925)

Securities Regulation Reforms	
Protection of sophisticated investors	• **"Bad boy" issuers under Reg D.** Mandates that the SEC preclude certain "bad boy" issuers from raising capital in private markets using Regulation D (Dodd-Frank §926 — see §5.2.2) • **Asset-backed securities disclosures.** Mandates that the SEC establish additional disclosures on asset-backed securities (such as debt obligations that are collateralized by mortgages — CDOs), even when offered to sophisticated investors in private markets (Dodd-Frank §943)
Broker-dealer regulation	• **Fiduciary duties on broker-dealers.** Requires the SEC to consider subjecting broker-dealers (securities firms), when they give investment advice to clients, to the same fiduciary "customer first" standards that apply to investment advisers (Dodd-Frank §913) • **Securities arbitration.** Mandates the SEC to prohibit or limit mandatory predispute arbitration in broker-customer disputes (Dodd-Frank §921)

CHAPTER 12

Duty of Care and the Business Judgment Rule

The board of directors manages and oversees the corporation's business and affairs. Judicial review of board decision-making and oversight is governed by the duty of care, which in turn is confined by the business judgment rule.

This chapter considers the articulated standards of care (§12.1) and their actual application under the deferential business judgment rule (§12.2). It then explains how the presumption that directors act in good faith with due care in the best interests of the corporation can be overcome (§12.3) and summarizes the available remedies (§12.4). Finally, the chapter describes the liability protections that directors have under exculpation provisions that arise in corporate charters and by statute (§12.5).

As you will discover in this chapter and those that follow, directors are insulated from liability in many ways. The business judgment rule and the exculpation provisions described in this chapter are two of the legs of a four-legged stool on which directors sit. The other two are the indemnification available to directors under corporate statutes and internal corporate processes (see §15.1) and directors' and officers' (D&O) liability insurance (see §15.2).

§12.1 STANDARDS OF CARE— ASPIRATIONAL GUIDANCE

In performing their functions, directors (and senior executives) are subject to both statutory and common-law standards of care. As you will discover, many of these standards are more *aspirational* than real. Because of the business judgment rule, directors rarely are held liable (or their decisions questioned) on the basis of directorial negligence. See §12.2 (below). In addition, many corporations have adopted exculpation clauses that further insulate directors from liability for their negligence. See §12.5 (below).

§12.1.1 Standards of Care

Statutory Standards

Many state statutes codify the standards for directorial behavior. Typical is MBCA §8.30 (as revised in 1998). Under the section, each *individual* director must discharge his duties in "good faith" and act "in a manner he reasonably believes to be in the best interests of the corporation." MBCA §8.30(a). In addition, members of the board must *collectively* become informed in performing their decision-making and oversight functions with "the care that a person in like position would reasonably believe appropriate under similar circumstances." MBCA §8.30(b) (replacing early, more stringent standard of "ordinarily prudent person"). Under many statutes, officers with discretionary authority are subject to similar standards. See MBCA §8.42(a).

Common-Law Standards

The articulated judicial standards follow much the same pattern as the statutory standards. The Delaware Supreme Court has stated that a party challenging a business decision must show the directors failed to act (1) in good faith, (2) in the honest belief that the action taken was in the best interest of the company, or (3) on an informed basis. *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984). In general, these judicial standards also apply to officers. See *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (confirming that officers have same fiduciary duties as directors, though without the possibility of exculpation available to directors).

§12.1.2 Facets of Duty of Care

Each of the *standards of care* articulated in the statutes and by the courts

identifies a facet of the *duty of care*.

Good Faith

The "good faith" standard requires that directors (1) be honest, (2) not have a conflict of interest, and (3) not approve (or condone) wrongful or illegal activity. See *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003) (holding that attitude of "we don't care about risks" breaches duty of good faith, a subset of the duty of loyalty). Fraudulent or self-interested action is subject to scrutiny under the director's duty of loyalty. See §13.2. Conscious disregard of corporate duties and intentional violations of positive law violate the director's duty of good faith. See §12.3.1 below.

Best Interests

The "best interests" standard involves the *substance* of director decision-making. The requirement that directors have a "reasonable belief" their decisions are in the corporation's best interests reflects both a subjective aspect (belief) and an objective one (reasonable). That is, directors must subjectively believe they are furthering the corporation's interests, and this belief must objectively be reasonable.

Under the "best interests" standard, a board decision must be related to furthering the corporation's interests. This standard embodies the "waste" standard, under which board action is invalid if it lacks any rational business purpose. See §12.3.2 below.

Informed Basis

The "informed basis" standard relates to the *process* of board decision-making and oversight. Directors must be informed in making decisions (see §12.3.3 below) to monitor and supervise corporate activities (see §12.3.4 below). In both capacities, directors must have at least minimal levels of skill and expertise. The "like position" formulation is meant to establish an objective standard that recognizes that "risk-taking decisions are central to the director's role." See Official Comment, MBCA §8.30 (replacing "ordinarily prudent person" formulation to avoid suggestion that benchmark is negligence). The "under similar circumstances" language has been understood to allow a court to take into account the complexity and urgency of the board's decision-making and oversight functions.

§12.1.3 Careless Directors Rarely Held Liable

The articulated care standards have a familiar ring—they sound in negligence. Just as there is liability for negligent driving that causes a traffic accident, you might assume that directorial liability regularly follows careless board decision-making that results in business failure. But in more than 150 years during which courts have articulated a directorial duty of care, there have been only a handful of cases in which directors and officers have been held liable for mere mismanagement uncomplicated by bad faith, illegality, fraud, or conflict of interest. What is really happening?

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§12.2 BUSINESS JUDGMENT RULE

To understand a director's duty of care, one must understand the famous "business judgment rule." The rule, which is both procedural and substantive, reflects a judicial "hands off" philosophy—the golden rule of corporate law. As explained by the courts, the business judgment rule is a rebuttable presumption that directors in performing their functions are honest and well-meaning, and that their decisions are informed and rationally undertaken. In short, the business judgment rule presumes directors do not breach their duty of care.

Although the business judgment rule is not statutorily codified, courts have inferred its existence even in states with statutory care standards. As the Official Comment to MBCA §8.30 explains, the statutory standards of conduct for directors do "not try to codify the business judgment rule [which] continues to be developed by the courts." For this reason, some commentators have characterized the statutory standards as *aspirational*, their legal effect profoundly diluted by the business judgment rule.

§12.2.1 Operation of Business Judgment Rule

The business judgment rule shields *directors* from personal liability and insulates *board decisions* from judicial review—the latter sometimes referred to as the "business judgment doctrine." The business judgment rule also protects officers and their decisions. See ALI Principles §4.01.

The business rule has two aspects, one substantive and the other

procedural. It describes the substantive *standard of review* to which director and board action should be submitted, and it creates a procedural *burden of proof* that requires the challenging party to rebut the presumption that directors act in good faith, in the best interests of the company, and with adequate information. Because of this burden and the procedural obstacles to overcoming the business judgment presumption (see §18.3, derivative suit procedures), claims that directors have breached their duty of care are often dismissed before trial.

§12.2.2 Justifications for the Business Judgment Presumption

The business judgment presumption has been justified on different grounds:

- **Encourages risk taking.** Shareholders expect the board to take business risks—the adage "nothing ventured, nothing gained" is at the core of why shareholders invest. Without the business judgment rule, directors might be too cautious. See *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049 (Del. Ch. 1996) (explaining that shareholders can absorb risk by investing in many companies).
- **Avoids judicial meddling.** Judges are not business experts. Further, derivative suit plaintiffs (and their lawyers) have incentives that may be at odds with the interests of the corporation and the body of shareholders. Corporate statutes reflect this notion and uniformly specify that corporate management is entrusted to the board of directors.
- **Encourages directors to serve.** Business people detest liability exposure. The business judgment rule encourages qualified persons to serve as directors and take business risks without fear of being judged in hindsight.

Some commentators have even suggested that the business judgment presumption should be absolute and corporate law should not enforce care standards. Mismanagement would be subject only to shareholder voting and the markets. If directors and officers perform poorly, the business will suffer and the corporation's stock price will fall. This will make it harder to raise capital. It will also make management vulnerable to shareholder activism, a

proxy contest, or even a takeover. Eventually, poor management will be replaced or the corporation will go bankrupt. Moreover, if the managers develop a reputation for poor judgment, they will become less attractive in the executive job market.

§12.2.3 Reliance Corollary

An offshoot of the business judgment presumption entitles directors to rely on information and advice from other directors (including committees of the board), competent officers and employees, and outsider experts (such as lawyers and accountants). In addition, directors can rely on others to whom the board has delegated its decision-making or oversight functions. This *reliance corollary* is contained in many statutes and widely accepted by the courts. See MBCA §8.30(c)(e) (revised in 1998). Under some statutes, it also extends to officers. See MBCA §8.42(b).

Particularly in public corporations, directors must rely on information from others. They cannot be expected to learn and know about the full range of the corporation's business. But to claim reliance, directors must have become familiar with the information or advice and must reasonably have believed that it merited confidence. In addition, directors can rely on each other. The "reasonable care" standard of the MBCA recognizes that directors typically perform their oversight and decision-making functions collegially. This means that directors in becoming informed can rely on each other's experience and wisdom. See Official Comment, MBCA §8.30 ("If the observance of directors' conduct is called into question, courts will typically evaluate the conduct of the entire board").

Directors, however, cannot hide their heads in the sand and claim reliance if they have knowledge or suspicions that make reliance unwarranted. Official Comment, MBCA §8.30 (directors remain subject to general standards of care in judging reliability and competence of source of information). For example, a director who knows that management has overstated earnings cannot rely on an auditor's opinion that earnings are properly stated. In addition, management directors (with greater familiarity with the corporation's business or expertise in a particular matter) have a correspondingly greater duty to independently verify information. See *In re Emerging Communications, Inc. Shareholder Litigation*, 2004 WL 1305745 (Del. Ch. 2004) (holding director with financial expertise liable for not

recognizing that price in “going private” transaction was unfair to shareholders). In general, though, the reliance corollary is more protective than the due diligence and reasonable care defenses available to directors charged with securities fraud. See §§5.3.2, 5.3.3.

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§12.3 OVERCOMING BUSINESS JUDGMENT PRESUMPTION

When a board decision is challenged, courts place the burden on the challenger to overcome the business judgment presumption by proving either (1) fraud, bad faith, illegality, or a conflict of interest (lack of good faith, see §12.3.1 below); (2) the lack of a rational business purpose (waste, see §12.3.2 below); (3) failure to become informed in decision-making (gross negligence, see §12.3.3 below); or (4) failure to oversee the corporation’s activities (inattention, see §12.3.4 below).

The MBCA (as revised in 1998) largely tracks these judicial categories and specifies *standards of liability*. A director can become liable for

- action not in good faith
- a decision the director did not reasonably believe to be in the corporation’s best interests or as to which the director was not adequately informed
- conduct resulting from the director’s lack of objectivity or independence, unless the director proves he believed the conduct was in the corporation’s best interests
- a sustained failure to be informed in discharging the director’s oversight functions
- receipt of an improper financial benefit

MBCA §8.31(a) (challenger must also show director not covered by charter exculpation provision, see §12.5, or the statutory safe harbor for conflict-of-interest transactions, see §13.4).

§12.3.1 Lack of Good Faith

A director loses the presumption that he was acting in good faith—and thus the protection of the business judgment rule—if the challenger shows fraud, the conscious disregard of duties, the condoning of illegality, or a conflict of interest.

Fraud

A director who acts fraudulently is liable, and any action tainted by the fraud can be invalidated, regardless of fairness. For example, directors who mislead shareholders in connection with shareholder voting cannot claim protection under the business judgment rule. See §10.3. Likewise, directors who knowingly disseminate false or misleading information to public trading markets breach a duty of disclosure, a subset of their duties of loyalty and good faith. *Malone v. Brincat,* 722 A.2d 5 (Del. 1998) (holding that misinformation in communications to shareholders, even though not requesting shareholder action, violates "duty to deal with shareholders honestly"). In addition, a director who knowingly or recklessly misrepresents a material fact to the board on which the other directors rely to the corporation's detriment can be held liable under a tort deceit theory.

Conscious Disregard

Directors who "consciously disregard" their responsibilities are liable for violating their duty of good faith. *Walt Disney Co. Deriv. Litig*., 906 A.2d 27 (Del. 2006). For example, directors can be liable for failing to call board meetings and acting as "stooges" for a controlling shareholder. *ATR-Kim Eng Financial Corp. v. Araneta,* 2006 WL 3783520 (Del. Ch. 2006). According to the Delaware courts, the duty of good faith is a subset of the duty of loyalty —thus, violating the duty of good faith cannot be exculpated. See §12.5 below.

As you can imagine, the financial crisis of 2008 has spawned the argument that directors in financial firms "consciously disregarded" subprime-mortgage risks, thus violating their duties of good faith. The argument, however, has fallen on mostly deaf judicial ears, given the absolving force of the business judgment rule. For example, when shareholders of Citigroup alleged that the firm's directors had failed to notice "red flags" brewing in the real estate and credit markets when they approved various investments in subprime loans, which eventually resulted in losses for the firm of $55 billion, the court dismissed the case and held that the alleged

warning signals did not evidence conscious disregard by the directors. At most, said the court, "They evidence that the directors made bad business decisions." *In re Citigroup Inc. Shareholder Deriv. Litig.,* 9643 A.2d 106 (Del. Ch. 2009) (pointing out that plaintiffs failed to allege board's risk management committee, charged with monitoring credit risk, had ignored the subprime risks).

Illegality

Directors who intentionally approve or consciously disregard illegal behavior by the corporation violate their duty of good faith, even if the directors were informed and the behavior benefited the corporation. Older cases described the duty of directors to abide by corporate and noncorporate norms as the "duty of obedience," a concept that continues to apply in nonprofit corporations.

For example, courts have said directors of for-profit corporations can be liable for approving

- bribery of state officials to protect an amusement park's illegal (and profitable) Sunday operations. *Roth v. Robertson,* 118 N.Y.S. 351 (Sup. Ct. 1909).
- bribery of foreign government officials, even though the practice was widespread. *Gall v. Exxon,* 418 F. Supp. 508 (S.D.N.Y. 1976).
- the dismantling of corporate plants and equipment to discipline unruly employees in violation of labor laws. *Abrams v. Allen,* 74 N.E.2d 305 (N.Y. 1947).
- a business plan that created strong incentives for employees to commit Medicare and Medicaid fraud to attract medical referrals. *McCall v. Scott,* 239 F.3d 808 (6th Cir. 2001).

Fiduciary rules against corporate illegality, however, produce a conundrum. By making scofflaw directors liable as a matter of *corporate* law, not the positive law that prohibits the behavior, corporate fiduciary duties become a fountainhead for the enforcement of business regulation. On the one hand, there may be many instances when approving illegal behavior maximizes profits for the corporation. On the other hand, condoning known corporate illegality would be an affront to noncorporate norms and could

undermine the legitimacy of the corporation.

Modern courts have recognized this tension. In *Miller v. AT&T*, 507 F.2d 759 (3d Cir. 1974), shareholders brought a derivative suit challenging AT&T's failure to collect a $1.5 million debt owed by the Democratic National Committee, a failure the plaintiffs said violated federal campaign finance laws. The Third Circuit accepted that under corporate norms the directors' business decision to forgive a debt is normally immune from attack. But the court held AT&T's failure to collect the DNC debt could be actionable if the directors had no "legitimate" business justification, aside from illegally currying political favor, for forgiving the debt. In other words, an illegal purpose alone cannot be a rational business purpose sufficient to trigger the business judgment rule.

Miller illustrates the curious result when corporate law is used to enforce noncorporate legal norms. One year after *Miller* was decided, the Supreme Court held that shareholders had no implied federal cause of action to enforce federal campaign spending laws. *Cort v. Ash*, 422 U.S. 66 (1975). Thus, shareholders were able to use *state fiduciary law* to obtain relief based on a federal statute that the Supreme Court interpreted precludes *federal relief* for shareholders.

Conflict of Interest

A director who is personally interested in a corporate action because he stands to receive a personal or financial benefit loses the business judgment presumption. This is true whether the director is an inside corporate employee or an outside independent director. The director's liability and the validity of the action depend on fairness standards that apply to conflict-of-interest transactions. See §13.3.

In addition, a director may become liable if a corporate action is approved because he is beholden to another person interested in the action. See MBCA §8.31(a)(2)(iii) (liability of director who lacks objectivity due to director's familial, financial, or business relation with interested person).

§12.3.2 Waste

The presumption of the business judgment rule also can be overcome if the action of the directors lacked a "rational" business purpose. The focus is on the merits of the board action or inaction—a substantive review of the

challenged decision. When the challenger claims a transaction wholly lacks consideration, the cases often speak of “waste” or “spoliation” of corporate assets. The absence of a rational business purpose powerfully suggests bad faith—that is, a conflicting personal interest, illegality, or deception.

Rational Basis

How much of a business justification is sufficient? Under the *rational purpose test*, even board decisions that in hindsight seem patently unwise or imprudent are protected from review and the directors shielded from liability so long as the business judgment was not “improvident beyond explanation.” *Michelson v. Duncan*, 407 A.2d 121 (Del. 1979); see also ALI Principles §4.01(c) (comment) (“removed from the realm of reason”).

Only when the board approves a transaction in which the corporation receives no benefit—such as the issuance of stock without consideration or the use of corporate funds to discharge personal obligations — have courts found corporate waste. See Official Comment, MBCA §8.31(a)(2)(ii) (stating that it is a rare case where corporation’s best interest is “so removed from realm of reason” or director’s belief “so unreasonable as to fall outside bounds of sound discretion”). The theme is to protect good-faith board decisions from judicial second-guessing.

Illustrative Cases

If it can be said that the corporation received some fair benefit, the matter is entrusted to the directors’ judgment. As the following two famous cases illustrate, courts regularly forgive even glaring business folly:

- ***Shlensky v. Wrigley,*** 237 N.E.2d 776 (Ill. App. 1968). Before the Chicago Cubs joined the rest of the major leagues with night baseball games, Cubs’ shareholders challenged the board’s refusal to play night baseball at Wrigley Field. The shareholders alleged night baseball would increase profits and pointed to higher night attendance for the Chicago White Sox and other teams around the league. Phillip Wrigley, the Cubs’ majority shareholder and dominant member of the board, thought “baseball is a daytime sport.” The court dismissed the plaintiff’s complaint, speculating that night baseball might cause the neighborhood around Wrigley Field to deteriorate, resulting in a decline in attendance

or a drop in Wrigley Field's property value.

- ***Kamin v. American Express Co.,*** 383 N.Y.S.2d 807 (Sup. Ct. 1976). The directors of American Express faced the choice of liquidating a bad stock investment at the corporate level (taking a corporate tax deduction for the loss) or distributing the stock to the shareholders as a special dividend (a taxable event for the shareholders). Although the choice seemed obvious, the board opted for the stock dividend, and shareholders sued. The directors explained they were concerned liquidation at the company level would have adversely impacted the company's *accounting* net income figures. The court found the concern sufficient. That is, the court accepted that appearances could be more important than actual cash effects.

Safety-Valve Cases

Are actions by the board ever irrational? Only a small handful of cases have found good-faith board action so imprudent as to fall outside the business judgment presumption. But under closer inspection, even these few cases where courts have found waste may not reflect disinterested misjudgment, but rather judicial use of care standards when a conflict of interest could be inferred, but not proved—that is, "safety valve" cases.

Consider *Litwin v. Allen*, 25 N.Y.S.2d 667 (Sup. Ct. 1940), the most famous of these cases. The court imposed liability on the directors of Guaranty Trust, a bank affiliate of J. P. Morgan & Company, for approving stock repurchase agreements (repos) in the tenuous stock market after the 1929 crash. Under the repos, Allegheny Corp. sold Guaranty Trust convertible 5.5 percent debentures at $100 par at a below-market price. In return for this discount, Guaranty Trust gave an option to Allegheny to repurchase the debentures at par in six months—in effect, a call option. Although Guaranty Trust could have sold the bonds immediately, realizing the purchase discount, it took a gamble that prices would rise and it could sell higher. When prices continued to fall and Allegheny failed to exercise its option (to repurchase), Guaranty Trust was left holding the bonds. It had bought the bonds at a favorable price and guessed wrong that the panic of 1930 had reached bottom.

The court faulted the directors for approving a transaction "so improvident, so risky, so unusual and unnecessary to be contrary to

fundamental conceptions of prudent banking practice"—precisely the kind of second-guessing precluded by the business judgment rule. Surely the Guaranty Trust directors, among the most experienced risk managers in banking, had not been inattentive to the repos' risk.

So what was really happening in *Litwin v. Allen*? Many commentators have explained the case as imposing a higher duty on directors of financial institutions, who frequently were defendants before the era of federal deposit insurance. But there may be another explanation. Allegheny was the holding company for the Van Sweringen empire in which J. P. Morgan & Company was deeply involved. Morgan's interest in buttressing Allegheny's sagging fortunes was surely not lost on the Guaranty Trust directors. Although the court agreed that there was no showing of conflict of interest, the court's use of a heightened care standard (a "safety valve") overcame this lack of proof.

§12.3.3 Gross Negligence

To claim the business judgment presumption in a decision-making context, directors must make reasonable efforts to inform themselves in making the decision. The focus is on procedure, and the courts assume diligent board deliberations ensure rational board action. Liability is generally based on "concepts of gross negligence." Compare MBCA §8.31(a)(2)(ii)(B) (director liable if not informed about decision "to an extent the director reasonably believed appropriate in the circumstances").

Trans Union

When are directors not adequately informed? The most famous and controversial answer comes from *Smith v. Van Gorkom* (*Trans Union*), 488 A.2d 858 (Del. 1985). In a 3-2 decision, the Delaware Supreme Court held the directors of Trans Union Corporation could be personally liable for not informing themselves adequately when they approved the sale of the company in a negotiated merger.

The case involved a friendly cash-out merger. The sequence of events, described in great detail in the court's opinion, paints the picture of a CEO (Van Gorkom) who initiated, negotiated, and promoted a merger agreement whose terms may have favored the acquirer (Pritzker). Shareholders brought a class action challenging the board's failure to become sufficiently informed.

The court recited a litany of errors by a board composed of five

management directors and five eminently qualified outside directors. According to the court, the directors had failed to inquire into Van Gorkom's role in setting the merger's terms; failed to review the merger documents; had not inquired into the fairness of the $55 price and the value of the company's significant, but unused, investment tax credits; accepted without inquiry the view of the company's chief financial officer (Romans) that the $55 price was within a fair range; had not sought an outside opinion from an investment banker on the fairness of the $55 price; and acted at a two-hour meeting without prior notice and without there being an emergency.

In response, the directors asserted they had been entitled to rely on Van Gorkom's oral presentation outlining the merger terms and on Romans's opinion. But the court held no reliance was warranted because Van Gorkom had not read the merger documents before the meeting and did not explain that he, not Pritzker, suggested the $55 price. In addition, the court pointed out that the directors had never questioned Romans about the basis for his opinion and had not asked about the views of senior management, who had strenuously objected to aspects of the agreement (including the price).

The *Trans Union* court rejected a number of arguments that normally would have carried the day under the business judgment rule. Consider the rational justifications given for the merger: the $55 merger price both reflected a significant premium over the then-$38 market price and was within internally calculated leveraged buyout ranges. The directors, who had significant business expertise and background knowledge of Trans Union's business, had no reason to doubt Van Gorkom's assertion of the merger's fairness. The board's approval was later conditioned on a "test market" during which other offers could be solicited. The board was operating under the time pressure of a Pritzker deadline. Outside counsel had advised the directors they might be sued for turning away an attractive offer.

What if the board had asked, read, and heard what it was charged with having failed? At most, the directors would have learned that Van Gorkom had negotiated on his own initiative a deal with a personal and business acquaintance, had proffered a price during the negotiations at the low end of a credible range of fair value, and had agreed to a merger with some disadvantageous terms that senior management objected to. Even if the directors had been fully informed, as eventually happened at a later meeting when they reapproved the merger, there is little to suggest they might have extracted a better deal. The court's second-guessing of boardroom procedures

has been harshly criticized.

Meaning of *Trans Union*

What are the *Trans Union* lessons? The case is among the few holding directors liable for a rational decision as to which there were no allegations of bad faith or self-dealing. Commentators have suggested various explanations:

- **Delaware reassertion.** The Delaware Supreme Court was giving teeth to Delaware fiduciary law, which during the 1970s and early 1980s had come under heavy criticism for being too lax. The Trans Union board's decisional failures provided a convenient target for the court to assert itself. Its emphasis on board processes also put a premium on good lawyering, presumably by the Delaware corporate bar.
- **Fast shuffle.** The case had self-dealing overtones. Van Gorkom was reaching retirement age, and the merger allowed him to realize an immediate $1.5 million increase in the value of his shareholding. As the *Trans Union* dissent pointed out, the majority seemed to believe the directors had been victims of a Van Gorkom—Pritzker "fast shuffle." In subsequent cases, the Delaware courts have readily faulted directors who approve transactions in which managers extract bribes from the acquiror as a condition for the transaction. See *Parnes v. Bally Entertainment Corp.*, 722 A.2d 1243 (Del. 1999) (finding breach of fiduciary duties when directors approved merger conditioned on CEO receiving special payments from acquiror).
- **End-period event.** A board's consideration of a cash-out merger deserves heightened review. When shareholders are cashed out in a merger, a faulty board decision cannot be corrected through the operation of product, securities, and control markets. For this reason, mergers and other "end period" decisions should be subject to more stringent review than typical operational decisions. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (*Cede II*) (finding care breach by directors who failed to inquire about negotiation and terms of merger); see also *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2005) (explaining *Trans Union* as "sale of entire company" for which board approval required by statute).
- **Antitakeover implications.** Perhaps *Trans Union* was meant to *promote*

> board discretion in future takeover cases. After the case, directors who receive an unsolicited offer for their company can put off the unwanted buyer on the ground that Delaware law requires them to take their time to first become fully informed.

Despite its importance to corporate fiduciary law, the *Trans Union* puzzle has yet to be fully solved.

§12.3.4 Inattention

Directors have oversight functions that go beyond making decisions at board meetings. Particularly in public corporations, directors are expected to monitor management, to whom is delegated day-to-day business. To carry out their duties, directors are presumed to have unrestricted access to all corporate information. *Kortum v. Webasto Sunroofs, Inc.*, 769 A.2d 113 (Del. Ch. 2000) (corporation has burden to permit director's inspection of corporate information related to directorial role). The monitoring duty requires directors to inquire into managers' competence and loyalty. A director cannot passively sit by, for example, if she knows that the corporation's treasurer is embezzling money. Judicial review has varied depending on whether the director is inattentive to *mismanagement* or to *management abuse.*

Inattention to Mismanagement

Courts have been reluctant to hold directors liable for inattention to mismanagement. A classic case is *Barnes v. Andrews,* 298 F. 614 (S.D.N.Y. 1924) (Learned Hand, J.). There a director—whose "only attention to the affairs of the company consisted of talks with the president [who was a friend] as they met from time to time"—was sued after the business failed because of the president's poor business judgment. Learned Hand concluded the passive director, though he had technically breached his duty of care, could not be liable because nothing indicated he could have prevented the business failure. Learned Hand pointed out that it would be impossible to know if the director could have saved the business. Even if the inquiry were possible, the business judgment rule teaches it should not be conducted by judges.

Nonetheless, a few cases (perhaps confusedly) have imposed liability for

mere inattention. See *Hoye v. Meek*, 795 F.2d 893 (10th Cir. 1986) (finding that bank director, whose family controlled the bank, violated duty of care under Oklahoma statute's "ordinarily prudent director" standard by not attending board meetings and not monitoring risky investment decisions of his son).

Inattention to Management Abuse

Courts have been less forgiving when a director fails to supervise management defalcations and deceit. In fact, most cases that impose liability on directors for care breaches—older bank cases and newer S&L cases—have involved directors who turned a blind eye to managers with their hands in the corporate till. Liability hinges on whether the director knew or had reason to know of the management abuse. Courts more readily infer knowledge of abuse in the case of management directors.

A modern (though not necessarily illustrative) example is *Francis v. United Jersey Bank,* 432 A.2d 814 (N.J. 1981). Mrs. Pritchard was the widow of the founder of Pritchard & Baird, a closely held reinsurance brokerage business. After her husband's death she became a director, but was inactive and knew virtually nothing about the business. She never read the firm's annual financial statements, which revealed that her sons were taking client funds in the guise of "shareholder loans." The court held her liable for failing to become informed and make inquiries and inferred that Mrs. Pritchard's laxity proximately caused the losses to the corporation. She could have brought her sons' illegal misappropriations to the attention of insurance officials.

Although *United Jersey Bank* seems to imply directors must inquire whenever management defalcation is possible, most modern cases do not go so far. Instead, inattentive directors are liable only if circumstances indicate they actually knew of or suspected management diversion. *United Jersey Bank* can be explained by its peculiar facts. The suit was brought by a bankruptcy trustee against the widow and her two sons, the only directors. After her husband died, Mrs. Pritchard had become listless and had started to drink heavily. During the proceedings she died, and the suit proceeded against her estate, whose beneficiaries were presumably her sons. The desire to add the estate's assets to the bankruptcy pool may explain the court's duty of care analysis.

Recent Delaware courts have used the duty of good faith to impose

liability on directors who fail to adequately monitor management misbehavior. By couching the analysis in terms of lack of "good faith," rather than lack of "care," director liability is not subject to exculpation under Del. GCL §102(b)(7) (see §12.5 below).

Monitoring Corporate Compliance

The requirement that directors know of or suspect management abuse extends to the duty of directors to monitor corporate illegality. In *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963), the court held that the business judgment rule shields directors who had failed to detect antitrust violations (criminal bid-rigging) by mid-level executives. According to the court, unless the director knew of or suspected the bid-rigging, they were not obligated to install a monitoring system. The MBCA *standards of conduct* regarding directorial oversight functions also reflect this view. In matters of legal compliance, "the director may depend upon the presumption of regularity, absent knowledge or notice to the contrary." Official Comment, MBCA §8.30(b).

More recent Delaware cases have held, however, that a board has a duty to install corporate monitoring and reporting systems to detect accounting irregularities and illegal behavior—even in the absence of "red flags." See *In re Caremark Int'l Inc.*, 698 A.2d 959 (Del. Ch. 1996) (approving settlement of derivative suit challenging board's failure to create monitoring system, which allegedly would have revealed illegal kickbacks by company to get Medicare/Medicaid patients). Given the greater activism expected of corporate directors and the increased penalties under the federal sentencing guidelines for crimes committed by organizations without compliance programs, boards act at their peril by not instituting monitoring systems to assure accurate information about the corporation's compliance with law, financial reporting, and business performance.

In 2006 the Delaware Supreme Court clarified the nature of a *Caremark* claim and explained that director oversight is subject to review under the duty of good faith, which the court characterized as a subset of the duty of loyalty. See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). The case involved a derivative suit brought by shareholders against directors of AmSouth Bancorporation seeking personal liability for their failure to implement a monitoring system required by the federal Bank Secrecy Act. The shareholders claimed that better oversight would have revealed that bank employees had unwittingly

allowed bank accounts to be used by a couple scoundrels running a Ponzi scheme (where returns to early investors are paid from investments by later investors). Federal banking authorities found that AmSouth's monitoring program was "materially deficient" and imposed record-setting fines and penalties of $50 million.

Nonetheless, the court held that the directors had not engaged in a *deliberate* failure to exercise oversight (or a *conscious disregard* of their responsibilities). The court found that the bank had implemented a monitoring system that was designed to present information on compliance with the Bank Secrecy Act requirements. That the system failed, according to the court, was not enough to establish "a sustained or systematic failure of the board to exercise oversight." The court pointed out that subjecting directors to personal liability for employee failures—that is, making out a *Caremark* claim—is "possibly the most difficult theory" in corporate law.

Despite the difficulties of bringing a *Caremark* claim, the Delaware courts have lately been receptive to claims that directors failed in their duty of oversight, specifically as it pertains to a corporation's overseas operations. In 2013, for example, the Delaware chancery court permitted *Caremark* claims to proceed in three separate cases involving challenges to board oversight of overseas operations, pointing out that directors who fail to act in the face of a known duty to act (namely, to ensure accurate accounting of business transactions) demonstrate a conscious disregard for their responsibilities and thus breach their duty of loyalty. See, e.g., *Rich v. Chong*, 2013 WL 3353965 (Del. Ch. 2013) (finding corporation's overseas compliance systems "woefully inadequate" by, among other things, carving out retail segment from general ledger, not detecting multiple unrecorded payments and accounts receivable, and incorrectly recording inventory movements).

§12.3.5 Oversight under Sarbanes-Oxley and Dodd-Frank

In response to Enron and other accounting scandals, the Sarbanes-Oxley Act of 2002 (see § 11.5.1) mandated new corporate oversight mechanisms—in the process federalizing large swaths of corporate behavior previously within the board's discretion under the business judgment rule. The Dodd-Frank Act of 2010 (see § 11.5.2) modified some of the Sarbanes-Oxley requirements.

Certification of SEC Filings and Internal Controls

As commanded by Sarbanes-Oxley, the SEC adopted rules requiring corporate officers of "reporting companies" (see §21.2.2) to certify the annual and quarterly reports filed with the SEC. Sarbanes-Oxley §302. Under SEC rules, the CEO and CFO each must certify that he reviewed the report and, based on his knowledge, that (1) it does not contain any material statements that are false or misleading, and (2) it "fairly presents" the financial condition and results of operation of the company—regardless of formal compliance with generally accepted accounting principles (GAAP). Exchange Act Rules 13a-14, 15d-14.

In addition, the officers must certify that they are responsible for establishing and maintaining "disclosure controls and procedures" that ensure material information is made known to them and that these internal controls were evaluated before making the report. Sarbanes-Oxley §302. If there are any significant deficiencies or changes in the internal controls or any fraud by those who operate them, the certifying officers must disclose this to the company's auditors and the board's audit committee. Exchange Act Rules 13a-15, 15d-15, 15d-14.

To impress upon certifying officers the gravity of these tasks, Sarbanes-Oxley enhanced the criminal sanctions for certifications that are knowingly or willfully false. Sarbanes-Oxley §906, 18 U.S.C. §1350 (requiring CEO and CFO to certify that periodic report "fully complies" with Exchange Act and "fairly presents" material financial condition and results). Knowing violations carry penalties up to $1 million and 10 years' imprisonment and willful violations up to $5 million and 20 years' imprisonment.

Internal Controls

In a significant expansion into state law, Sarbanes-Oxley increased the scope (and burden) of internal controls on reporting companies beyond financial accountability. Sarbanes-Oxley §404. Internal controls are, as commanded by Sarbanes-Oxley, the SEC adopted rules requiring reporting companies to include in their annual report a statement of management's responsibility over internal controls, a statement of how those controls were evaluated and an assessment of their effectiveness (or weaknesses) over the past year, and a statement that the company's auditors attested to management's assessment. Items 307 and 308, Reg. S-K; Exchange Act Rel. No. 47,986 (2003).

From the beginning, the internal controls requirement was controversial. It was argued that such controls were not cost justified—particularly for smaller public companies. Responding to these arguments, the SEC permitted smaller public companies (with a market cap of less than $75 million) to delay until 2008 their implementation of internal controls and also exempted such companies from the auditor attestation requirement through 2010. In the Dodd-Frank Act of 2010, Congress made the attestation exemption permanent. Dodd-Frank §989G (adding §404(c) to Sarbanes-Oxley Act); Exchange Act Rel. No. 62,914 (2010). Thus, smaller public companies are only subject to the requirement that management certify the company's internal controls.

Whistleblower Protection

Sarbanes-Oxley gave whistleblowers in public companies special protections. The audit committee of listed companies must establish procedures to receive anonymous submissions from employees on "questionable accounting or auditing matters." Sarbanes-Oxley §301, Exchange Act §10A(m). In addition, whistleblowers in public companies who report securities fraud to a federal agency, Congress, or a company supervisor cannot be retaliated against. Sarbanes-Oxley §806; 18 U.S.C. §1514A (public company and specified individuals cannot "discharge, demote, suspend, threaten, harass, or in any other manner discriminate" because of lawful reporting). If there is retaliation, the whistleblower can file a complaint with the U.S. Department of Labor within 90 days. OSHA investigates the complaint, and civil penalties (back pay and attorney fees) can be imposed by the agency or in a court action against retaliating individuals and the company. Retaliation can also result in criminal penalties, including fines and prison terms up to ten years. Sarbanes-Oxley §1107; 18 U.S.C. §1513(e).

Enforcement of the Sarbanes-Oxley whistleblower provisions, however, has been mixed. In response, Dodd-Frank increased whistleblower protection by, among other things, providing whistleblower plaintiffs who claim retaliation a jury-trial right, double pay and reinstatement, as well as doubling the statute of limitations for whistleblower claims. Dodd-Frank §922 (adding new Exchange Act §21F). Dodd-Frank also sought to encourage whistleblowers by providing a monetary reward of between 10—30 percent of amounts recovered by the SEC in an enforcement action against the offending issuer, provided the recovery is above $1 million. Exchange Act

Regulation 21F (implementing whistleblower reward program, which also creates incentives for employees to report company abuses internally; whistleblowers criminally convicted are not eligible for reward). See Exchange Act Rel. No. 54,545 (2011).

Audit Committee Regulation

Sarbanes-Oxley mandated that U.S. stock exchanges adopt standards on the composition and functions of the audit committee of listed companies. Sarbanes-Oxley §301, Exchange Act §10A(m). Under these standards, the audit committee of listed companies (including foreign issuers and small business issuers) must be composed entirely of independent directors, as defined by the SEC. In addition, companies must disclose whether at least one member of the committee is a financial expert. Sarbanes-Oxley §407, Reg. S-K, Item 401 (defining “audit committee financial expert” as one with significant auditing, accounting, financial, or comparable experience).

The audit committee must be responsible for appointing, compensating, and overseeing the company’s independent audit firm—a curtailment of the power of the full board and shareholders over outside accountants. The audit committee (not the board) must have the authority to hire independent counsel and other advisors, their fees to be paid by the listed company. Rule 10A-3; Exchange Act Rel. No. 47,654 (2003).

Code of Ethics

Sarbanes-Oxley commanded the SEC to require reporting companies to disclose whether they have adopted a code of ethics applicable to their top financial and accounting officers—and if not, explain why. Sarbanes-Oxley §406; Item 406, Reg. S-K. Any changes or waivers of the ethics code for such officers must be promptly disclosed on Form 8-K. Exchange Act Rel. No. 47,235 (2003) (see §21.2.2).

“Up the Ladder” Reporting by Lawyers

As commanded by Sarbanes-Oxley, the SEC promulgated a rule requiring lawyers “appearing and practicing before” the SEC to report evidence of a material violation of securities law or breach of fiduciary duty (or similar violation) to the company’s general counsel or CEO. Sarbanes-Oxley §307; 17 C.F.R. §205. Failing an appropriate response, the lawyer must then report to the company’s audit committee, another committee composed exclusively

of outside directors, or the full board. Although not free from doubt, this "up the ladder" reporting obligation applies both to inside and outside lawyers who represent the issuer before the SEC or advise on securities matters—whether the issuer is a reporting company or going public.

A securities lawyer's failure to report "up the ladder" can be the basis for SEC discipline and sanctions; no private right of action is created. This federalization of lawyer professional duties reminds corporate/securities lawyers that they work for the corporation and its shareholders, not corporate executives.

§12.4 REMEDIES FOR BREACHING THE DUTY OF CARE

If a challenger overcomes the business judgment presumption and shows the board's decision was uninformed or lacked a rational basis, any director who participated in the decision is liable for breaching a duty of care. The next question becomes what remedies the challenger can expect.

§12.4.1 Personal Liability of Directors

If board action violates the duty of care, courts have held that each director who voted for the action, acquiesced in it, or failed to object to it becomes *jointly and severally* liable for all damage that the decision proximately caused the corporation. Under most state statutes, a director who attends a meeting at which an action is approved is presumed to have agreed to the action, unless the minutes of the meeting reflect the director's dissent or abstention. MBCA §8.24(d). Some statutes allow a director who has not voted for the action to register her dissent or abstention by delivering written notice at or immediately after the meeting. MBCA §8.24(d).

Not every care breach, however, creates liability for damages. Some courts require the challenger to show the director's action (or inaction) proximately caused damage to the corporation. *Barnes v. Andrews,* 298 F. 614 (S.D.N.Y. 1924). Proximate cause is important in oversight cases. When directors disregard management abuse, courts readily find proximate cause. But when directors are inattentive to mere mismanagement, courts are less willing to make the causal finding. It would be anomalous to impose liability

on a director for being inattentive to business mistakes that are themselves protected by the business judgment rule.

The MBCA's liability provisions state that directors who breach their care duties are liable in damages only if the violation proximately caused harm to the corporation or shareholders. MBCA §8.31(b)(1). Nonetheless, in a Delaware case involving uninformed board decision-making, the court refused to make proximate cause an element of the plaintiff's case and shifted the burden to the careless defendants to prove the challenged transaction's "entire fairness." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (*Cede II*). Under this approach, lack of proximate cause becomes an affirmative defense.

§12.4.2 Enjoining Flawed Decision

Courts can also enjoin or rescind board action unprotected by the business judgment doctrine. Some commentators have suggested that it should be easier to enjoin corporate action than to impose personal liability. Courts, nonetheless, have not explicitly distinguished between cases to impose personal liability and to enjoin board action.

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§12.5 EXCULPATION OF DIRECTORS' CARE FAILURES

§12.5.1 Exculpation Statutes

After *Trans Union* a perception grew that service as a corporate director had become more risky. During the late 1980s, insurance premiums for D&O insurance increased, and there were reports of directors who declined to serve for fear of liability exposure. In response, Delaware and most other states enacted exculpation statutes that authorize charter amendments shielding directors from personal liability for breaching their duty of care—a "raincoat" protecting directors from liability.

Delaware	MBCA
No personal liability for breaches of duty, though director remains liable for • breaches of duty of loyalty, • acts or omissions not in good faith or that involve intentional misconduct or knowing illegality, • approval of illegal distributions, and • obtaining a personal benefit (such as by insider trading).	No liability for money damages to corporation or shareholders, except liability for • financial benefits he received to which he is not entitled, • intentional infliction of harm on the corporation or its shareholders, • approving illegal distributions, or • an intentional violation of criminal law.
Del. GCL §102(b)(7).	MBCA §2.02(b)(4).

The exculpation provision can be included in the articles of a newly formed corporation or added by amendment with board and shareholder approval. None of the exculpation statutes affects the granting of equitable relief.

Note on Exculpation of Officers

One important thing to notice is that the statutes provide for exculpation only of directors, not officers—on the theory that the promise of exculpation is necessary to attract *directors* to the board and encourage their good-faith decision-making. Thus, officers are fully subject to the duty of care, their gross negligence not exculpable. See *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (confirming that officers are subject to same fiduciary duties as directors).

This means it is possible that persons who serve both as directors and officers of a corporation may be exculpated for their actions as directors, while remaining subject to liability for actions in their capacity as officers. See *Chen v. Howard-Anderson*, 87 A.3d 648 (Del. Ch. 2014) (finding directors exculpated for preferring outside bidder, though inside directors who served as officers subject to claims they preferred bidder to benefit themselves).

§12.5.2 Effect of Exculpation

Exculpation provisions have been the subject of judicial interpretation, particularly in Delaware. Early cases focused on the meaning of the statutory exceptions. For example, exculpation provisions have been interpreted not to

cover violations of disclosure duties, a theory of liability often used whenever a transaction involves shareholder voting. See *Zirn v. VLI Corp.*, 621 A.2d 773 (Del. 1993) ("equitable fraud" in a third-party merger). Left open are questions about the lines between care, loyalty, and good-faith violations. For example, when directors are sued for care violations, the real reason for liability (such as tacit approval of a managerial conflict of interest) suggests the statutory exceptions would not exculpate the directors from money damages. For example, if the Trans Union directors consciously acceded to Van Gorkom's "fast shuffle," their failure to become informed may have constituted "action not in good faith"—unprotected under a Delaware §102(b)(7) charter provision.

The Delaware courts have sought to explain the procedural effect of an exculpation provision in the corporate charter. In one case, the court held that plaintiffs challenging director conduct have the burden to allege well-pleaded facts that the conduct falls within the exceptions of the Delaware statute. *Malpiede v. Townson*, 780 A.2d 1073 (Del. 2001). But in another case, the court concluded that an exculpation provision is "in the nature of an affirmative defense," requiring directors to establish each of its elements, including good faith in a parent-subsidiary merger. *Emerald Partners v. Berlin*, 726 A.2d 1215 (Del. 1999) (*Emerald I*). Then in a second appeal in the same case, the court decided that when claims of care violations are mixed with claims of disloyalty and lack of good faith, the question of exculpation arises only *after* a finding that the transaction was not entirely fair. Only then can the trial court decide whether the unfairness arose from behavior challenged in the exculpated care claims or the nonexculpated loyalty or bad faith claims. *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) (*Emerald II*).

Notice the effect of this procedural jumble. When a plaintiff adequately pleads conduct that falls within the statutory exceptions, directors charged with *both* care and loyalty or good-faith violations must go through a full trial on both claims before interposing their affirmative exculpation defense—which once presented presumably wipes clean any damages claims based only on care violations.

§12.5.3 Evaluation of Exculpation

Exculpation statutes and the charter provisions they have spawned raise

troublesome questions. Is it good policy to allow directors to escape their care responsibilities? Does shareholder approval of an exculpation provision, particularly through proxy voting in a public corporation, provide meaningful assurances that shareholder interests are furthered?

One important study strongly suggests the shareholders (in stock trading markets) think exculpation statutes eviscerate care liability and disserve shareholders. The study found that share prices of companies incorporated in Delaware fell 2.96 percent compared to companies incorporated in other jurisdictions over the months surrounding the effective date of the Delaware "charter option" statute. The study also found that when particular Delaware corporations adopted a charter limitation their stock price experienced a second (somewhat smaller) drop. Bradley & Schiapani, *The Relevance of the Duty of Care Standard in Corporate Governance,* 75 Iowa L. Rev. 1 (1989).

Examples

1. EnTrade, a publicly traded company incorporated in an MBCA jurisdiction, is an energy trading firm that creates a marketplace for energy producers, carriers, and users. Offering an online system for buying and selling electricity and natural gas, along with energy transportation services, EnTrade is the largest energy broker in the country. In addition, to make participation in EnTrade's market more attractive, the company offers its customers "risk management" products that allow customers to buy financial contracts to protect themselves against price fluctuations. For example, an electric utility in California can use EnTrade to purchase electric power from a low-price industrial cogenerator in Louisiana, along with transmission services to get the power to California and a "hedging" contract that protects the utility if the market price falls. It is a brilliant business model that has won EnTrade recognition as the most innovative U.S. company by *Fortune Magazine*—for five years running. (These examples, drawn loosely from SEC filings of Enron Corp. and the February 2002 "Report of Investigation" by a special investigative committee of the Enron board, are wholly fictitious. For an excellent description and analysis of the Enron debacle, see William Bratton, *Enron and the Dark Side of Shareholder Value,* 76 Tul. L. Rev. 1275 (2002).)

   The success of EnTrade has attracted competitors offering similar energy trading systems, often at less cost. Even as EnTrade's revenues

continue to grow impressively, its net income has grown more slowly—EnTrade's margins are shrinking. In response, EnTrade's management proposes a bold strategy. The company will expand its energy trading operations to other countries and begin to trade nonenergy commodities, as well. Although the company has no experience in these areas, the hope is that techniques used for energy trading in the United States can be used in other countries and in nonenergy markets such as pulp and paper, steel, and even telecommunications bandwidth. After some deliberations, the board approves the expansion plan.

a. Sherron, an EnTrade shareholder, learns of the board's approval of the expansion and thinks it is a huge business mistake. Sherron wants to stop the expansion in court. How and on what theory?
b. The company spends $1.2 billion on a fiber optic network to run the company's expanded trading system. Sherron believes the money has been misspent and wants the directors to reimburse the corporation. On what theory?
c. Despite the state-of-the-art computer network and 1,700 new employees, the expansion project shows no signs of profitability. Six months after the expansion plan is put into effect, the company's stock has lost 40 percent of its value. Without knowing more, what chance does Sherron have of succeeding on either of these two claims?

2. As Sherron delves into the board's approval of EnTrade's expansion plan, she learns more. Which will support her challenge of the plan?
   a. Online trading of telecommunications bandwidth (the biggest aspect of EnTrade's expansion plan) is not a new idea. Other companies have tried it and have uniformly discovered that the telecommunications market is not ready. In fact, finding that acting as a bandwidth broker is hugely unprofitable, these other companies have all withdrawn from the business.
   b. When the EnTrade board met to approve the expansion plans, the company's CEO, Acosta, failed to tell the directors that telecommunications companies (some with more resources than EnTrade) had considered the idea of creating a bandwidth brokerage service and rejected it.

c. Acosta told the board that 40 percent of telecommunications companies in marketing surveys said they were interested in the concept of a bandwidth market. He failed to mention that 50 percent of the respondents who reviewed an online trading prototype said it did not fit their needs and they would never use it.

d. Acosta owns a majority interest in a company called Mastico which will offer consulting services in EnTrade's bandwidth trading operations. Acosta reveals his interest in Mastico, and the board members are aware of EnTrade's plans to hire Mastico as part of the company's expansion into bandwidth trading.

e. Deere & Carbo, the company's outside lawyers, opined that the Mastico deal is fair to EnTrade, even though the lawyers failed to question or review the way in which EnTrade has guaranteed Mastico's obligations.

3. Problems for EnTrade mount. A key to EnTrade's online energy trading is its offering of risk management to traders through "hedge" contracts. Under these contracts EnTrade acts as principal, guaranteeing its online customers protection against the risks of shifting commodity prices, interest rates, foreign currencies, and even stock prices. Although EnTrade has assured its shareholders that it has instituted its own risk management programs to protect the company from exposure to sudden price swings, EnTrade is not well hedged and lacks adequate reserves. The Commodity Futures Trading Commission (CFTC), the federal regulator of commodities markets, investigates and threatens to sue EnTrade for "engaging in the business of commodity futures trading" without satisfying a host of regulations, including financial standards applicable to a "designated commodities futures market." At the next board meeting, CEO Acosta reports on the CFTC's position. Experienced, outside legal counsel opines there is a good chance a court would reverse the CFTC's jurisdictional grab, and the board authorizes a lawsuit against the CFTC.

a. The EnTrade board approves further steps in the company's expansion plan, including more aggressive, longer-term risk management programs that put the company at even greater risk if energy prices fall. The board does not seek authorization from the CFTC. If Sherron sues to enjoin the company's risk management

program, is the board's decision to continue it protected by the business judgment rule?

b. The CFTC obtains a court injunction against EnTrade's continuing to offer risk management products, and the court imposes a substantial fine against EnTrade for marketing commodities futures without CFTC approval. Are the EnTrade directors liable to the corporation for approving the illegal conduct?

c. It turns out EnTrade's risk management practices were more aggressive than authorized by the board. EnTrade traders routinely understated the company's risk exposure by failing to "mark to market" their hedge contracts. This means the company's financial disclosure seriously misstates the company's contingent liabilities. The board, however, had never instituted a reporting system to keep track of the value (and exposure) of the company's proprietary risk management products. Are the EnTrade directors liable for not monitoring the company's risk management business?

4. The courts uphold the CFTC assertion of jurisdiction over EnTrade's risk management business, and Congress does not provide an exemption. All told, the company loses $150 million in business expenses, litigation costs, and regulatory penalties in its bid to be an unregulated commodity futures market. (This amount does not include the large losses the company eventually experiences when energy prices fall and it is forced to close its many "unhedged" positions.) Shareholders bring a derivative suit against the EnTrade board for failing to become adequately informed about the legality of the company's risk management business.

   a. The minutes of the meeting at which the board decided to continue in the risk management business despite the CFTC's position reveal the following: Director Nessum was not present; Director Rowland recused herself from the decision; Director Adams abstained from voting; and the remaining six directors voted to approve continuing the business. Which directors can be held liable?

   b. Director Rowland, who recused herself at the meeting, now claims that even if she had voted against the decision her dissent would not have changed the outcome. Does this affect her liability?

   c. At the time of the board's decision, the EnTrade articles exculpated directors from personal liability to the corporation "to the full extent

permitted by law." Does this provision insulate the EnTrade directors from liability?

d. Assuming the directors are not exculpated, are they liable for all of EnTrade's risk management losses?

5. EnTrade also owns natural gas utilities and pipelines—old-fashioned "hard assets." In addition to its aggressive risk management practices, the company uses its hard assets to create cash—adding even more luster to its soaring stock price. How? EnTrade moves hard assets worth billions into affiliated entities, many of them majority owned by EnTrade and most of them financed by borrowings from outside lenders (such as Citigroup and JP Morgan Chase) that take EnTrade stock as loan collateral. This means that EnTrade has leveraged its own stock to create cash in the affiliates, which then comes pouring into EnTrade. Only if EnTrade's stock price falls below preset thresholds will there be a problem. But as the stock market becomes concerned about EnTrade's investments and the risks in its core energy trading business, its stock price falls—triggering the collateral obligations that EnTrade owes to outside lenders of the affiliates. EnTrade's board was largely oblivious about the gravity of these contingent liabilities, which constitute nearly 40 percent of the company's net worth.

a. To extricate itself from this potential mess, EnTrade negotiates a stock-for-stock merger with DuoNergy (see §36.2). Under the merger agreement, DuoNergy will infuse new cash into EnTrade's online trading business, and EnTrade's shareholders will exchange their shares for shares of DuoNergy. The EnTrade board approves the merger and recommends it to EnTrade shareholders, but fails to become fully informed about the contingent liabilities or to mention them to the shareholders. Is this a breach of the directors' fiduciary duties?

b. The court finds that the EnTrade directors breached their fiduciary duties to become informed in the merger. Are the directors liable for the shareholders' losses when the contingent liabilities, which DuoNergy assumed in the merger, force the acquiring company into bankruptcy?

Explanations

1. a. Sherron might bring a derivative action on behalf of the corporation to enjoin the directors from carrying out their expansion plan. She might claim the directors violated their duty of care to the corporation in approving the risky plan. Absent any indication of dishonesty, illegality, or conflict of interest, she could claim the directors were not sufficiently informed in approving the plan or that they could not have believed it was a valid business risk. MBCA §8.30(a) requires that directors

   - act in a manner that the directors reasonably believe to be in the best interests of the corporation
   - become informed in their decision-making function with the care that a person in a like position would reasonably believe appropriate under similar circumstances

   Sherron might argue the plan is improvident and no reasonable director could believe it would maximize corporate returns. See MBCA §8.31(a)(2)(ii)(A). She might argue the directors did not have enough information concerning the costs and risks of the expansion. See MBCA §8.31(a)(2)(ii)(B).

   b. Sherron might claim, on the same grounds she sought to enjoin the plan, that the directors be held liable for any damages proximately caused by their duty of care violation. See MBCA §8.31(b)(1). If the directors breached their care duties—because the plan is wasteful or the directors were grossly negligent in approving it—each director who approved it or was at the meeting and failed to object can be held liable (jointly and severally) for any losses the plan causes the corporation. See §8.24(d) (directors present at meeting deemed to have assented to action taken, unless dissent or abstention from action entered in minutes or by written notice).

   c. Next to none. The board's approval of the expansion plan is protected by the presumptions of the business judgment rule, which applies despite the broadly worded standards of MBCA §8.30. The rule insulates the board's decision from attack and shields the directors from liability. Under the business judgment presumption, Sherron must show one of the following:

   - the decision was *not in good faith* (tainted by fraud, conscious disregard, illegality, or a conflict of interest)
   - the decision was *wasteful* (cannot rationally be said to be in the best

interests of the corporation)

- the directors were *grossly negligent* (failed to inform themselves about the plan)

That is, a showing of negligence is not enough. Instead, Sherron must show bad faith, an utter lack of business justification, or a collapse in the decision-making process. She thus faces dismal odds of proving a care breach. Although MBCA §8.31 seems to codify *standards of liability* that parallel the MBCA §8.30 *standards of conduct*, courts have continued to superimpose the business judgment presumption despite statutory standards. Fiduciary standards, largely a matter of judge-made law, build on the principles of delegated risk taking and centralized management embodied in the business judgment rule.

2. a. Probably not support. Sherron could argue the telecommunications industry's aversion to online trading of bandwidth suggests the EnTrade directors could not reasonably believe the project was in the best interests of the corporation. See Official Comment to MBCA §8.30(a)(2) ("reasonably believes" includes objective element). But the business judgment rule is a formidable shield. To impose on corporate directors industry-wide caution would kill corporate risk-taking. Directors have broad latitude to experiment, and to fail, without being second-guessed or exposed to liability.

   b. Probably not support. Although this information might be relevant to "like position" directors, the business judgment rule teaches that courts should not second-guess the process of business decision-making. Directors, of necessity, make decisions on incomplete information, often based on hunches and intuition. Lawyers can always dream up inquiries that the directors should have made, but the business judgment rule does not require courtroom-like thoroughness. The rule allows directors to act in an indeterminate business climate on imperfect information.

   The few cases that have faulted directors for not making sufficient inquiries have generally arisen in the context of hostile takeovers (where directors have ineluctable conflicts of interest) and negotiated mergers (where directors face fewer long-term incentives). In their function of deciding operational matters, directors have had wide

latitude to take risks and rely on information from corporate subordinates. See MBCA §8.30(d) (absent knowledge that makes reliance unwarranted, director entitled to rely on corporate executives whom the director reasonably believes to be reliable and competent in the information provided).

c. Probably not support. Even though Acosta's failure to mention the surveys may have been fraudulent—an intentional omission of a material fact—Sherron would have difficulty showing the board's reliance was unwarranted. See MBCA §8.30(d). She would have to argue that the board's approval of the expansion plan was tainted by fraud and unprotected by the business judgment presumption. If the board had reason to rely on Acosta (he had never been known to provide misleading information), then a shareholder challenge would be unavailing. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) (*Cede II*) (concluding that a conflict of interest that affects one director does not necessarily remove board decision from business judgment rule). Of course, the board could later decide to fire or discipline Acosta—in fact, the possibility of such internal controls is at the heart of the business judgment presumption.

If, however, Sherron can show that reliance by the directors on Acosta's misleading presentation was unwarranted, the board action might be subject to attack. Personal liability of the directors, however, would be another matter. As in the cases involving directors' monitoring duties, directors making uninformed decisions are liable only if they should have known of management fraud.

In addition, consider Acosta's liability. Although the board decision might not be subject to attack, his misleading presentation might have violated his fiduciary duties as a corporate officer. See MBCA §8.42(a). If Acosta misled about the surveys for personal reasons, the business judgment rule would withdraw its protective presumption. Moreover, if it was obvious that the board would have wanted to know the full survey results, he could not have reasonably believed that withholding the information was in the corporation's best interests. Nonetheless, if there was some valid business reason for not describing the surveys fully or if it was a good-faith lapse, the business judgment rule would protect his actions.

d. Probably support. The business judgment rule does not protect a board decision if a director's conflict of interest may have tainted the decision-making process. See §13.2 (judicial suspicion of director self-dealing transactions). Although the board decision may be informed and the directors acted in good faith, where the transaction involves an interested director or senior officer, courts scrutinize the deliberative process and its outcome more closely. It would not be enough that the board merely knew of Acosta's conflicting interest. The board would also have to inquire into the fairness of the terms and price of Mastico's deal with EnTrade. See MBCA §8.60 (defining "required disclosure" in a director's conflicting interest transaction to include nature of conflict and facts respecting the subject matter of the transaction). The broad (and vague) care standards provide a convenient means for courts to adjust their scrutiny as the influence under which the board operates changes.

e. Probably support. The failure of outside counsel to fulfill its professional duties by conducting a slipshod investigation into a self-dealing transaction's terms and fairness can have repercussions on the transaction's validity. Not being informed on the critical issue of fairness can be the basis for invalidating the board's approval of the Mastico deal. See Official Comment to MBCA §8.62 (board approval of director's conflicting interest transaction "must be conducted in light of the overarching provisions of section 8.30(a)").

In addition, the Deere & Carbo lawyers may be subject to SEC discipline and sanctions under the new "up the ladder" reporting requirements. Under the rules, securities lawyers working for a reporting company (or one about to go public) must report "evidence of material violation" of the securities laws or breach of fiduciary duty by the company or its officials. 17 C.F.R. §§205.2, 205.3. The lawyer is first supposed to report the violation to the company's general counsel (or also the CEO) and, failing their response, to the board's audit committee or the board itself.

3. a. Perhaps. To overcome the business judgment presumption, a shareholder would have to show that the board's decision to expand the risk management program either was so improvident as to be beyond explanation or was grossly uninformed. The *possible* illegality of the test marketing, though a significant business risk, does not mean the

directors violated a duty to the corporation. Directors are not guarantors of corporate legality.

To show a breach of *substantive* care, Sherron would have to show the board proceeded without a rational business purpose. Any rational justification insulates the board's action from attack. For example, with energy trading increasing, the board could speculate that longer-term risk management products would fill an important market niche. These products would give the company a competitive advantage in the more competitive online energy trading market, and regulation is not certain. The CFTC's assertion of jurisdiction might be overturned on appeal. The CFTC might eventually authorize the product. And Congress might create a statutory exemption (which actually happened for Enron). A reasonable business person might conclude the *potential* benefits outweigh the risks—which is enough under the rational basis test.

To show a breach of *procedural* care, Sherron would have to show the board knew so little it could not have acted rationally. This will be difficult. The EnTrade board knew of the CFTC determination and relied on the opinion of counsel that a court might reverse it. Under the business judgment rule, the directors have significant latitude to assess the risks and benefits of a course of action, even if only with sketchy information.

b. Perhaps not. A shareholder could argue the directors are liable for not acting in good faith by approving illegal behavior. Earlier cases accepted this argument on the assumption corporate law should not shield those who disregard or flout the law. Imposing liability on directors promotes corporate responsibility. More recent cases recognize that directors act in an environment of legal uncertainty. At the time the directors approved the risk management expansion, it was not certain that CFTC approval was required to offer "hedge" contracts in its energy trading business. The directors could argue they reasonably relied on the advice of counsel that its risk management business would ultimately be found not to be subject to federal regulation.

Enforcing noncorporate norms (here financial capability laws) through corporate fiduciary law highlights the tension of making

directors both agents of shareholder wealth maximization and guardians of legal compliance. This is particularly so if the CFTC regulations do not themselves penalize corporate decision-makers for selling a risk management product while its legality is being tested in court. The business judgment presumption arguably is not overcome unless directors know or have reason to know their action is illegal. See *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963). From the *standpoint of shareholders*, the corporation (or shareholders in a derivative action) should not be asked to police noncorporate responsibilities. These responsibilities are more appropriately enforced under the regulatory regime, as happened in this case when the CFTC sought an injunction and penalties against the corporation. If this is insufficient to deter unwanted decisions, they can be increased—as has happened, for example, with penalties imposed on corporations and corporate actors under the federal sentencing guidelines. See Sarbanes-Oxley §§805, 807, 903, 904, 905 (increasing jail sentences for mail and wire fraud, securities fraud, and ERISA violations, and mandating review of federal sentencing guidelines on obstruction of justice and white-collar fraud).

c. Yes. A failure to be attentive to corporate illegality may breach a director's duty of good faith (a subset of the duty of loyalty). The EnTrade directors violated their duty of good faith by failing to implement a monitoring system to detect illegal behavior—something effectively required by the Delaware courts. See *In re Caremark Int'l, Inc.*, 698 A.2d 959 (Del. Ch. 1996) (suggesting current law requires monitoring systems to detect both corporate illegality and management irregularities); *Stone v. Ritter*, 911 A.2d 362 (Del. 2006 (accepting *Caremark* framework). The case for having a monitoring system is strong, as in EnTrade's situation, when there are indications corporate activities may be illegal.

4. a. Each director who was present at the meeting and failed to object or abstain from the action is assumed to have assented. MBCA §8.24(d). These directors may be held jointly and severally liable for the resulting loss suffered by the corporation. Consider the various excuses:

- Nessum, the absent director, is not liable under the MBCA, though some courts have imposed liability on absent directors who later acquiesced in wrongful board decisions.

- Adams, the abstaining director, is not liable so long as the minutes of the meeting reflect his abstention.
- Rowland, the nonparticipating director, is liable because she was present at the meeting. Unless during or immediately after the meeting she delivered written notice of an abstention or dissent, a procedure authorized by the MBCA, she is assumed to have acquiesced in the action.
- All directors who voted for the action are fully liable; there is no explicit right of contribution. Under the MBCA, they have no right to dissent or abstain once they have voted for the action.

b. Subject to an exculpation provision in the articles, the recused director is jointly and severally liable along with the other present, approving directors. Liability is to the corporation for all losses proximately caused by the board decision—namely the expansion of the risk management business. By failing to dissent, the nonparticipating director failed to register her views and perhaps remedy a mistaken decision.

c. Perhaps. Under MBCA §2.02(b)(4), in a corporation with an exculpation provision, a director can be liable for damages to the corporation or its shareholders only if his actions fit into one of four narrow categories. None seems to apply to the EnTrade directors in their approval of the expansion project:

- The directors did not receive financial benefits to which they were not entitled. The only exception might be any benefits Acosta received in connection with his interests in Mastico, the bandwidth consulting firm.
- The directors did not intentionally harm the corporation or its shareholders. On the assumption the directors believed that the risk management business would eventually be profitable and not subject to CFTC regulation, their approval represented good-faith business risk-taking.
- The directors did not approve illegal distributions, as defined in MBCA §6.40 (payments to shareholders). See MBCA §8.33 (liability for illegal distributions subject to standards of MBCA §8.30).
- The directors, from appearances, did not intentionally violate criminal

law. Although the directors understood there was a risk the company would violate CFTC regulations, there is no indication they or the corporation violated criminal law. Nonetheless, an argument could be made that an actual criminal conviction is not necessary and that engaging in risky financial arrangements is a criminal offense. This argument, however, would convert corporate fiduciary law into a prosecutor of criminal norms. See Official Comment, MBCA §2.02 (exculpation does not extend to "improper conduct so clearly without any societal benefit that the law should not appear to endorse such conduct").

The exculpation clause is meant to insulate directors from liability for well-meaning business risk-taking so long as the director does not enrich himself, does not carelessly approve unlawful distributions to shareholders (thus harming creditor interests), or consciously disregard potential harm to corporate interests or violation of noncorporate positive law. See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) (refusing to find breach of duty of good faith, on theory "bad outcome" cannot be equated with "bad faith").

d. Not necessarily. Even if the directors breached a duty for not inquiring sufficiently about the legality of the risk management business, their liability is not automatic. The MBCA places the burden on the challenging shareholder to show that the directors' inattention was a proximate cause of any corporate injury. See MBCA §8.31(b). This might be difficult if other causes, besides the lack of CFTC supervision, might explain the risk management losses. For example, if rogue traders caused the losses by having EnTrade assume unwarranted risks, the board's inattention to the CFTC issue might not be seen as the proximate cause of the losses. Moreover, a court might decide that even if the board had complete information about the CFTC jurisdictional issue, it would have reached the same decision. That is, the lack of information was not a proximate cause of the board's decision and the company's losses.

Some courts, including now those of Delaware, would shift the burden to the inattentive directors to show their decision was nonetheless entirely fair to the corporation—that is, the board adequately informed itself that the risk management business was a good business risk.

5. a. Perhaps. At first blush, it might seem that the EnTrade board's approval of the merger without becoming informed about and disclosing "bad news" at the company actually produced a windfall for EnTrade shareholders, and a major headache for DuoNergy. Nonetheless, once these contingent liabilities are assumed by DuoNergy, they will have a negative effect on EnTrade shareholders, who (remember) acquired DuoNergy shares in the merger. That is, the board has a duty to inform itself about the company's business, including the contingent liabilities that DuoNergy is acquiring, because these liabilities will be material to EnTrade shareholders once they own DuoNergy shares. The board in a merger must ascertain both the value of the company's assets and liabilities, and the value of the consideration that the shareholders are receiving. On both counts, the EnTrade directors' failure to become informed about such significant liabilities—and to tell the shareholders—would seem a breach of duty.

b. Not necessarily. Even though the EnTrade board should have become informed about EnTrade's liabilities when it sold the company, the shareholders' losses are not the result of the merger, but rather the earlier leveraging of the company's assets using company stock as collateral. In fact, bankruptcy would have been swifter and more certain had there not been a merger. Although the board should have become informed about this perilous leveraging of the company, and its failure may have violated the directors' fiduciary duties, this was not the failure that shareholders challenged. In fact, some Delaware cases hold that fiduciary breaches that existed before a corporate merger cannot be challenged by former shareholders—that is, the shareholders' fiduciary claims are lost in the merger. *Kramer v. Western Pacific Indus., Inc.*, 546 A.2d 348 (Del. 1988).

CHAPTER 13

Duty of Loyalty—Self-Dealing Transactions

A self-dealing transaction tests a fiduciary's loyalty to the corporation. When the fiduciary and the corporation are counterparties, the fiduciary plays two roles. She has a personal interest as a party to the transaction, and she participates in the corporate decision to approve the transaction.

This chapter discusses director self-dealing transactions—sometimes referred to as "director conflict-of-interest transactions." It describes self-dealing transactions (§13.1), the judicial approach to such transactions (§13.2), the various judicial fairness tests (§13.3), the statutory "safe harbors" (§13.4), and the remedies for self-dealing (§13.5).

Other chapters discuss other forms of self-dealing: the compensation of corporate executives (Chapter 14); parent-subsidiary dealings (Chapter 17); promoter's early dealings with the corporation (Chapter 29); and management buyouts and takeover defenses (Chapter 39). The taking of corporate opportunities and competing with the corporation, though also implicating the duty of loyalty, do not involve self-dealing with the corporation. See Chapter 16 (directors); Chapter 17 (controlling shareholders).

§13.1 NATURE OF SELF-DEALING

§13.1.1 Unfair Diversion of Corporate Assets

From the corporation's perspective, director self-dealing on unfair terms is like embezzlement. Little distinguishes the director who steals $100,000 from the company safe and the director who sells swampland to the corporation for $102,000 that is worth only $2,000. Although the land sale might seem like business as usual, the transaction effectively diverts to the transacting director corporate assets equal to the difference between the land's market value and its purchase price.

§13.1.2 Direct and Indirect Self-Interest

Self-dealing director transactions fall into two broad categories. In each instance, the director's conflicting interest risks that the transaction will be contrary to the corporation's best interests.

Direct Interest

In its classic form, self-dealing occurs when the corporation and the director herself are parties to the same transaction. MBCA §8.60(1)(i). Examples include

- sales and purchases of property, including the corporation's stock
- loans to and from the corporation
- the furnishing of services by a nonmanagement director (such as when the corporation's outside lawyer, accountant, or investment banker sits on the board)

Indirect Interest

Self-dealing also occurs when the corporate transaction is with another person or entity in which the director has a strong personal or financial interest. Courts generally look through the structure of the transaction to the substance of the director's interest. These include corporate transactions

- with the director's close relatives. See MBCA §8.60(1)(i), (3) (defining

"related person" to include spouse, child, grandchild, sibling, parent, or family trust).

- with an entity in which the director has a significant financial interest. See MBCA §8.60(1)(i), (ii) (another entity in which director has a significant financial interest or in which he is a director, partner, agent, or employee).
- between companies with interlocking directors. See MBCA §8.60(1)(ii). In the case of a parent-subsidiary relationship, the duties of interlocking directors are subsumed in the question of the duties of the controlling shareholder. See Chapter 17.

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§13.2 JUDICIAL SUSPICION OF SELF-DEALING TRANSACTIONS

Corporate law's suspicion of director self dealing grows out of two assumptions. First, human nature tells us the self-dealing director will advance her own interests in the transaction to the detriment of the corporation. Second, the nature of group dynamics tells us the other directors will identify with their interested colleague even if they do not themselves have a financial interest in the transaction.

Nonetheless, transactions with insiders often make possible business deals that would otherwise be unavailable to the corporation from outsiders. Thus, modern corporate law allows self-dealing when "fair" to the corporation. Fairness is a multifaceted concept—a director satisfies her duty of loyalty if she is able to show the self-dealing transaction meets a mishmash of procedural and substantive tests.

§13.2.1 Early Rule of Voidability

Nineteenth-century courts, borrowing from the law of trusts, flatly prohibited self-dealing by directors. Self-dealing transactions, whether fair or not, were either *void* or *voidable* at the request of the corporation. The prohibition assumed that self-dealing rarely offers the corporation business opportunities not obtainable from other sources and that it is improbable that "disinterested" directors—those who do not have a direct or indirect interest

in the transaction—will be immune to the actual and tacit influence of their interested colleagues.

§13.2.2 Substantive and Procedural Tests

The rule of voidability was abandoned at the turn of the century. See Marsh, *Are Directors Trustees?*, 22 Bus. Law. 35 (1966). Since then, courts have articulated a variety of substantive and procedural fairness tests. The substantive tests focus on the transaction's price and terms to measure whether the interested director advanced her interests at the expense of the corporation. The procedural tests focus on the board's decision-making process to measure whether the approving directors are disinterested in the transaction and independent of the influence of the interested director.

Over time, courts have articulated various review standards—with recent decisions focusing more on process than substance.

- **Substance plus process.** At first courts upheld self-dealing only if the transaction was fair on the merits *and* was approved by a majority of disinterested directors. See *Globe Woolen Co. v. Utica Gas & Electric Co.,* 121 N.E. 378 (N.Y. 1918) (invalidating one-sided supply contract entered with dominating director who failed to advise board of disadvantages).
- **Substance only.** By the 1950s, many courts upheld self-dealing if the court determined the transaction was fair on its merits. Approval by disinterested directors was not necessary.
- **Board process.** As the importance of outside directors grew in the 1980s, courts upheld director self-dealing provided disinterested, independent directors approved the transaction. See *Puma v. Marriott,* 283 A.2d 693 (Del. Ch. 1971) (upholding "independent business judgment" of disinterested directors who initiated and negotiated purchases from company's controlling family).
- **Shareholder process.** Courts have upheld self-dealing or shifted the burden to the challenger to prove unfairness—if disinterested shareholders (a majority or all) approved the transaction. Approval by disinterested directors has not been necessary.

The various tests ultimately turn on who decides whether the self-dealing transaction was in the corporation's best interests: a court, the board of directors, or the shareholders. See MBCA Chapter 8, Subchapter F, §§8.60-8.63 (comprehensive safe harbor for directors' conflicting interest transactions approved by appropriate action of directors or shareholders).

§13.2.3 Burden of Proof

Once a challenger shows the existence of a director's conflicting interest in a corporate transaction, the burden generally shifts to the party seeking to uphold it to prove the transaction's validity. See MBCA §8.61(b)(3) (absent disinterested approval by board or shareholders, transaction must be "established to have been fair to the corporation"); *Lewis v. S. L. & E., Inc.*, 629 F.2d 764 (2d Cir. 1980) (holding that interested defendants have burden of proving transaction between two affiliated corporations was fair and reasonable to the corporation).

Under the process-oriented approaches of the ALI Principles of Corporate Governance and Subchapter F of the MBCA, the challenger has the burden to prove the transaction's invalidity when disinterested directors or shareholders have approved the transaction. ALI §5.02(b); MBCA §8.61(b).

§13.2.4 No Business Judgment Presumption

The conflicts that permeate a self-dealing transaction rebut the business judgment presumption that directors act in good faith. See §12.3.1. Thus, for example, a company's sponsorship of a radio music program—normally subject to deferential review under the business judgment rule—becomes subject to intensive judicial review when the wife of the company's president was hired as a featured performer on the program. See *Bayer v. Beran*, 49 N.Y.S.2d 2 (Sup. Ct. 1944) (reviewing the process by which the board approved the program, the nature and quality of the program, and the wife's artistic competence and compensation).

Courts, however, have drawn a sharp distinction between directors who have an interest in the challenged transaction and "disinterested, independent directors"—that is, those directors who have neither a direct nor indirect interest in the transaction and are not dominated by the interested director. The business judgment rule protects from personal liability disinterested,

independent directors who approve a self-dealing transaction in good faith. See §12.3.4.

One question that arises is whether self-dealing transactions can be sanitized by prior agreement or in the articles or bylaws. That is, can fiduciary duties be waived? "Fiduciary waivers" are recognized in LLCs, which are seen as more contractual than corporations. In fact, many LLC statutes permit the parties to agree to "specific types or categories of activities" that do not violate the duty of loyalty, provided the agreement is not "manifestly unreasonable." See ULLCA §103(b)(2). This is often given as a reason for choosing the LLC over the corporation. Courts, however, have been less willing to permit corporate agreements that waive the duty of loyalty in self-dealing transactions. See *Sutherland v. Sutherland,* 2009 WL 1177047 (Del. Ch. 2009) (agreement that placed corporate self-dealing transactions beyond judicial review would be "contrary to public policy"). Thus, the corporation remains less contractual, and more regulatory, than the upstart LLC form.

§13.2.5 Self-Dealing by Officers and Senior Executives

In general, officers and senior executives are subject to the same self-dealing standards as directors. See *Gantler v. Stephens,* 965 A.2d 695 (Del. 2009) (confirming that officers are subject to same fiduciary duties as directors); see also ALI §5.02(a), comment d. Nonetheless, because officers and senior executives generally will be expected to devote themselves primarily, if not exclusively, to the corporation, some cases indicate that such persons' transactions with the corporation are judged under more exacting standards.

§13.2.6 Aiding and Abetting Liability

Courts accept that an outsider who aids and abets a breach of fiduciary duty in a self-dealing transaction can also be liable. See *CDX Liquidating Trust v. Venrock Associates,* 640 F.3d 209 (7th Cir. 2011) (Posner, J.). Even though the outsider owes no fiduciary duties to the corporation, its "knowing participating" in the fiduciary's breach makes out a claim if the breach proximately results in damages to the corporation. See *Gatz v. Ponsoldt,* 925 A.2d 1265 (Del. 2007). But an outsider that merely negotiates with the board

and seeks favorable terms for itself is not liable for aiding and abetting, but an outsider that attempts to exploit conflicts of interest on the board can become liable.

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§13.3 JUDICIAL "FAIRNESS" TESTS

Under the traditional approach to self-dealing transactions, courts have applied both substantive and procedural standards of fairness.

§13.3.1 Substantive "Fairness"

A *substantive fairness* standard, first articulated by the courts in the 1940s, continues to be widely accepted. See *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66 (Cal. App. 1952) (requiring that self-dealing transaction be "fair and reasonable"). Under this standard, which examines whether the director's interests won out over the corporation's interest, courts accept the fairness of self-dealing if the court concludes the transaction was in the corporation's best interests. Substantive fairness—sometimes called "intrinsic fairness"—has two aspects:

- **Objective test.** The self-dealing transaction must replicate an arm's-length market transaction by falling into a range of reasonableness. Courts carefully scrutinize the terms of the transaction—principally the price.
- **Value to corporation.** The transaction must be of particular value to the corporation, as judged by the corporation's needs and the scope of its business.

Both aspects of the fairness test involve significant judicial meddling in business matters and, ultimately, a judicial evaluation of the transaction's merits. See *Shlensky v. South Parkway Building Corp.*, 166 N.E.2d 793 (Ill. 1960); Official Comment to MBCA §8.61 ("Note on Fair Transactions").

Some cases and commentators suggest that substantive fairness is a flexible concept that varies with the degree of self-interest. That is, the level of scrutiny increases (or decreases) with the intensity of the director's self-

interest. For example, courts impose less scrutiny on transactions between corporations with interlocking directors compared to transactions with directors in their personal capacity. The MBCA reflects this differential review and treats an interlocking-director transaction as a "director's conflicting interest transaction" only if so significant that it would normally require board approval. MBCA §§8.60(1)(ii), 8.61(a).

§13.3.2 Procedural "Fairness"— Process of Board Approval

Courts have also inquired into the process of board approval, showing various levels of deference if the transaction is approved by informed, disinterested, and independent directors. Courts sometimes refer to a combination of procedural and substantive fairness as "entire fairness."

Judicial review of corporate processes examines whether the directors who approved the transaction (even disinterested ones) lacked independence and acceded to their interested colleague. In reviewing the process, courts have focused on three procedural elements: (1) disclosure to the board, (2) composition of the board (or committee) that approved the transaction, and (3) role of the interested director in the transaction's initiation, negotiation, and approval.

Disclosure

Even when self-dealing may be fair on the merits, courts have invalidated the transaction if there was outright fraud in connection with its approval. Where there is no fraud, but only allegations of inadequate disclosure, courts have taken a variety of approaches. Some courts have said that full disclosure is a factor bearing on the transaction's fairness; others have required that there be disclosure only of the conflict of interest to put the board on guard; still others have required full disclosure of all material information, including the profit the interested director stood to make in the transaction. See *State ex rel. Hayes Oyster Co. v. Keypoint Oyster Co.,* 391 P.2d 979 (Wash. 1964) (invalidating transaction even though terms were fair on ground that director failed to disclose his interest). Each approach reflects different assumptions about whether full disclosure will give the board a meaningful opportunity to review the proposed transaction and to negotiate more favorable terms. See

ALI Principles, comment to §5.02(a)(1).

Board (or Committee) Composition

Some courts have upheld self-dealing transactions approved by disinterested directors, applying a less exacting standard of review that approximates business judgment deference. See *Puma v. Marriott*, 283 A.2d 693 (Del. Ch. 1971) (without inquiring into fairness, accepting “independent business judgment” of disinterested directors who initiated and negotiated purchases from company’s controlling family). Other courts, though while still reviewing the transaction’s fairness, have shifted the burden of proving unfairness to the plaintiff—if the self-dealing is approved by a majority of disinterested directors. See *Cooke v. Ollie*, 1997 WL 367034 (Del. Ch. 1997) (upholding loans by insiders to corporation in desperate need of funds). The ALI Principles combine both a burden-shifting and modified fairness standard; Subchapter F of the MBCA makes disinterested approval conclusive.

The directors who approve the self-dealing transaction must be both “disinterested” and “independent.” See *Orman v. Cullman*, 794 A.2d 5 (Del. Ch. 2002) (distinguishing “interest” and “independence” in case challenging fairness of merger involving company’s management). A director is “disinterested” if he has no *direct* financial interest in the transaction, or *indirect* financial interest through close family ties or business relationships, that would affect his judgment. He is “independent” if he is neither beholden to nor dominated by the interested director. *Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co.*, 496 N.E.2d 959 (Ohio 1986) (applying Delaware law, domination means more than being selected by the interested director to serve on the board, but acting as requested without independent judgment).

Sometimes these concepts are conflated. For example, Subchapter F of the MBCA defines a “qualified director” as one who is not a party to the transaction, does not have a beneficial financial interest that would influence the director’s judgment, and has no familial, financial, professional, or employment relationship that would influence the director’s vote on the transaction. MBCA §8.60.

Role of Interested Director

Although earlier cases held that the interested director’s negotiation of a self-

dealing transaction or her participation in the board's decision-making process invalidated the transaction, many modern statutes and recent cases allow the interested director to negotiate, participate, and vote without necessarily undermining the transaction's validity. See former MBCA §8.31 (replaced in 1989 by Subchapter F). An interested director's negotiation or participation, however, may evidence that the interested director dominated the other directors, undermining the advantage of disinterested approval.

Many modern statutes facilitate disinterested approval by easing quorum requirements for self-dealing transactions. Some statutes dispense with quorum requirements if the self-dealing transaction is approved by a majority of (but at least two) disinterested directors. See MBCA §8.62(c); former MBCA §8.31(c). These statutes overrule the early common-law rule that required disinterested directors to constitute a quorum of the full board. Other statutes allow interested directors to be counted for quorum purposes, even though they do not participate at the meeting.

What happens if an interested director discloses his conflict in a transaction with the corporation and then convinces his fellow directors that the transaction is nonetheless fair? At least one case holds that although disclosure may insulate the transaction from attack, the interested director remains liable for breaching his fiduciary duties. See *CDX Liquidating Trust v. Venrock Associates*, 640 F.3d 209 (7th Cir. 2011) (Posner, J.) (disinterested directors approved bridge loan in reliance on interested director, whose venture capital firm gave loan to company on terms highly favorable to firm). This approach seems a bit bizarre in that it would be possible for an interested transaction to be upheld because the conflict was fairly disclosed, while the interested director was held responsible for the transaction's unfairness. That is, the transaction could be both fair and unfair at the same time.

§13.3.3 Shareholder Ratification

Courts have shown substantial deference to self-dealing transactions approved or ratified by a majority of informed, disinterested shareholders.

Majority Ratification

Where a majority of the shares are cast by informed shareholders who neither have an interest in the transaction nor are dominated by those who do, most

courts do not require that a defendant show "fairness." Instead, courts review the transaction under the business judgment rule and shift the burden to the plaintiff to show the transaction constituted waste—that is, no person of ordinary sound business judgment would say that the consideration was fair. See *Aronoff v. Albanese*, 446 N.Y.S.2d 368 (App. Div. 1982) (shareholder majority approved self-dealing rent reduction and rent-free lease modifications).

Delaware courts have followed this approach in cases where the self-dealing was by a *noncontrolling shareholder*. In such a case, approval by informed, disinterested shareholders of a transaction with the noncontrolling shareholder not only extinguishes any claim the board had acted without due care, but also leads disloyalty claims to be viewed under the business judgment rule. See *In re Wheelabrator Technologies Litigation*, 663 A.2d 1194 (Del. Ch. 1995) (merger with 22 percent shareholder). Disinterested shareholder ratification of transactions with *controlling shareholders*, however, is less cleansing and only shifts the burden to the challenger to show unfairness. See *Kahn v. Lynch Communication Systems*, 638 A.2d 1110 (Del. 1994). The different standards reflect the concern that controlling shareholders are in a better position to manipulate or unfairly influence the process of the shareholder vote.

Critical to shareholder ratification is complete and fair disclosure to the shareholders. Thus, when a board pursued a reclassification plan that assured the incumbency of the company's CEO and directors—rather than respond to an outside bid for the company—the Delaware Supreme Court held that shareholder approval of the reclassification plan was not sufficient to absolve the defendants. The shareholders had been misled, the court concluded, when they were told the board had conducted "careful deliberations" about the outside bid. Thus, the "entire fairness" standard applied to the interested transaction, not the business judgment rule or the proportionality *Unocal* standard (see §39.2.3). *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (cleansing effect of ratification does not apply when shareholders approve charter amendment, but only when shareholders approve board action that "does not legally require shareholder approval to become effective").

Courts have been suspicious of self-dealing transactions if shareholder ratification is by a majority of shareholders interested in the transaction. *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66 (Cal. App. 1952); *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976) (leaving burden with

defendants to show “intrinsic fairness” of transaction ratified by interested shareholders). Under some conflict-of-interest statutes, including the MBCA, shares voted by an interested shareholder are not counted for purposes of shareholder ratification. MBCA §8.63(b); former §8.31(d). Nonetheless, many statutes permit a majority of shares held by disinterested shareholders to constitute a quorum. MBCA §8.63(c); former §8.31(d).

Unanimous Ratification

If self-dealing is ratified unanimously by all of the shareholders or by a sole shareholder, courts agree that it cannot be set aside even under a waste standard so long as there is no injury to creditors. Effective ratification depends on full disclosure to shareholders of the director’s conflicting interest.

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§13.4 STATUTORY “SAFE HARBORS”

Because judicial self-dealing standards are often vague, there has been a movement toward adopting “safe harbor” tests that provide certainty to corporate planners seeking to ensure the validity of transactions between the corporation and its directors. Some courts, including Delaware’s, have interpreted “interested director” statutes (which ostensibly remove the cloud of voidability from self-dealing transactions) as creating a safe harbor so that properly approved self-dealing transactions are subject only to business judgment review. Likewise, Subchapter F of the MBCA and the ALI Principles of Corporate Governance adopt safe harbors meant to ensure the validity of self-dealing transactions if properly approved.

For each of the safe harbors, the initial question is whether there has been proper approval—that is, by qualified directors or qualified shareholders, at a meeting with the necessary quorum, and accompanied by adequate disclosure. If so, judicial review is muted or extinguished. If not, judicial review reverts to the common-law fairness standards described in §13.3.

§13.4.1 ”Interested Director” Statutes

Many modern statutes codify the abandonment of the flat prohibition against self-dealing, though without explicitly specifying when self-dealing is valid.

A good example is former MBCA §8.31(a) (rescinded in 1989), which states that a transaction *"shall not be void or voidable solely for the reason"* that a director (or an entity in which the director has an interest) is a party to a transaction with a corporation if

(1) the material facts are disclosed to the board, and a majority of disinterested directors authorized the transaction, or
(2) the material facts are disclosed to the shareholders, and the shareholders vote to approve the transaction (under some statutes the shareholders must be disinterested), or
(3) a court determines the transaction to be fair.

On their face, these "interested director" statutes are ambiguous. Do they merely reverse the common-law voidability rule for self-dealing transactions, leaving the *validity* of such transactions to judicial fairness review? Or do they create "safe harbors" that remove from judicial scrutiny properly approved transactions? Some courts have concluded the statutes do not displace judicial fairness review. See *Cookies Food Products v. Lakes Warehouse*, 430 N.W.2d 447 (Iowa 1988) (interpreting Iowa's "interested director" statute to still require judicial review of "good faith, honesty, and fairness" in self-dealing transaction); *Remillard Brick Co. v. Remillard-Dandini Co.,* 241 P.2d 66 (Cal. App. 1952) (interpreting California's "interested director" statute not to displace judicial role to ensure self-dealing transaction is "fair and reasonable").

Delaware courts have wrestled with the state's "interested director" statute. Del. GCL §144. At first, Delaware courts construed the statute as removing the shadow of automatic voidability, but without displacing the court's role to measure the transaction's entire fairness (both substance and procedure). See *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976). Delaware courts treated disinterested director approval as merely shifting the burden to the plaintiff to prove the transaction was not entirely fair. See *Cinerama, Inc. v. Technicolor, Inc.,* 663 A.2d 1134 (Del. Ch. 1994), citing *Kahn v. Lynch Communication Systems*, 638 A.2d 1110 (Del. 1994).

But, as Delaware has relied more and more on disinterested directors to resolve corporate conflicts, Delaware courts have concluded the statute creates a safe harbor for self-dealing transactions, if approved by fully informed, disinterested, and independent directors. *Marciano v. Nakash*, 535

A.2d 400 (Del.1987) (suggesting in dicta that proper approval "permits invocation of the business judgment rule"); *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114 (Del. 2006) (upholding issuance of preferred stock to director, which was approved by committee of disinterested directors that considered alternative financing plans and received fairness opinion on challenged issuance). In effect, the Delaware courts have decided that properly informed and qualified directors are superior at determining the value of a self-dealing transaction to the corporation than a reviewing judge.

§13.4.2 MBCA Subchapter F

MBCA §8.61(b) —the heart of Subchapter F—validates a director's conflict-of-interest transaction if it was

- disclosed to and approved by a majority (but not less than two) of qualified directors (MBCA §8.62), *or*
- disclosed to and approved by a majority of qualified shareholders (MBCA §8.63), *or*
- established to be fair, whether or not disclosed (MBCA §8.61(b)(3)).

Judicial review of board approval is thus limited to whether the directors were "qualified directors" and whether the disclosures were adequate. Official Comment, MBCA §8.61(b). Although an earlier version of Subchapter F suggested a court had the latitude to determine whether the self-dealing transaction was "manifestly unfavorable to the corporation," the current Subchapter F makes clear that judicial inquiry is foreclosed if the criteria of the safe harbor are met.

Judicial review of shareholder validation is similarly limited to whether a majority of disinterested shareholders approved or ratified the transaction after requisite notice and disclosure of the conflict. Neither the MBCA provisions nor the official comments suggest the court should engage in any substantive review—such as for waste—if the process satisfied the statutory safe harbor.

Some commentators have criticized Subchapter F for effectively removing self-dealing substantive review from the courts and placing it in the hands of disinterested directors or shareholders. The subchapter, first adopted

in 1989, has not been well received in states adopting the MBCA. As of 2011, only 15 of the 38 MBCA jurisdictions have included the subchapter.

Only a few cases have interpreted the Subchapter F safe harbor, though they suggest a judicial willingness to defer to internal corporate processes. In *Fisher v. State Mut. Ins. Co.*, 290 F.3d 1256 (11th Cir. 2002), an insurance company sold one of its subsidiaries to a newly formed corporation owned by two of the company's directors. The insurance company's board created a special committee, which negotiated and approved the sale. When a shareholder challenged the transaction, the corporation argued the sale satisfied the safe harbor for "board action" under Subchapter F. Despite allegations that the interested directors had failed to disclose material information about the subsidiary, the court held the interested directors' fiduciary duties to the purchasing corporation (which they themselves had formed) barred their full disclosure to the special committee, and they thus met the terms of the safe harbor. See MBCA §8.62(b) (full disclosure not required if interested directors disclose their interest and play no part in the deliberations or vote on the transaction). Given the safe harbor, the court refused to consider the plaintiff's further allegations of waste and fraud.

§13.4.3 ALI Principles of Corporate Governance

The ALI Principles of Corporate Governance also adopt a safe harbor approach. The Principles recommend a disjunctive test under which director self-dealing is valid if *after full disclosure*

- a court finds the transaction was fair when entered into, or
- a majority of disinterested directors (not less than two) approved or ratified the transaction, or
- a majority of disinterested shares approved or ratified the transaction.

ALI Principles §5.02. By requiring full disclosure in every case, the focus of judicial review is on disclosure adequacy even when the transaction is substantively fair or approved by disinterested directors or shareholders.

The ALI Principles contemplate diluted judicial review of the substance of a self-dealing transaction validated by disinterested directors. The court must conclude the transaction "could reasonably be believed to be fair to the

corporation." ALI Principles §5.02(a)(2)(B). The burden, however, is on the challenger to show disclosure was inadequate, the approving directors were not independent, or the transaction fails this watered-down fairness standard. The ALI Principles, unlike the MBCA, specify that self-dealing transactions validated by shareholders remain subject to judicial review under a substantive waste standard. Thus, minority shareholders who vote against the transaction can still complain if no reasonable business person would conclude the corporation received fair benefit.

The ALI Principles treat self-dealing standards as default rules. Disinterested directors or shareholders can authorize in advance specified types of self-dealing transactions that can be expected to recur in the company's ordinary course of business. ALI Principles §5.09(a). This standard must be stated in the articles or bylaws, or by board or shareholder resolution. ALI Principles §1.36.

§13.4.4 Summary Chart

The following chart summarizes the safe harbor approaches under the Delaware "interested director" statute, the MBCA Subchapter F, and the ALI Principles:

	Safe Harbor	Judicial Review
Delaware (§144)	Board: • material facts disclosed or known to directors • board or committee in good faith authorizes • majority of the disinterested directors • disinterested directors may be less than quorum	business judgment presumption
	Shareholders: • material facts disclosed or known to shareholders • specifically approved in good faith by vote of shareholders	waste (?)
	Court: • transaction fair to corporation • as of time approved	conclusive

(continued)

	Safe Harbor	Judicial Review
MBCA (Subchapter F)	Board: • after required disclosure • board or committee approves • majority (but not less than two) of qualified directors • majority of qualified directors constitutes quorum	"not manifestly unreasonable to corporation"
	Shareholders: • after required disclosure • approved by majority of qualified shareholders	conclusive
	Court: • established to be fair, whether or not disclosed	conclusive
ALI Principles (§5.02)	Board: • after full disclosure • approved or ratified by board or committee • majority of disinterested directors (not less than two)	"could [not] reasonably be believed to be fair"
	Shareholders: • after full disclosure • approved or ratified by majority of disinterested shares	waste
	Court: • transaction was fair when entered into	conclusive

Although all three follow a similar approach, there are subtle differences. The ALI Principles, for example, require full disclosure to the corporate decision-making body, even if neither of the procedural safe harbors applies. Delaware does not require actual disclosure, if the material information is already known to the directors or shareholders. Moreover, each approach leaves room for judicial review of board approval—"good faith" in Delaware, "manifestly unreasonable" under the MBCA, and "reasonable belief" under the ALI Principles.

Just as the judicial standards of review are not uniform, so too the statutory standards!

§13.5 REMEDIES FOR SELF-DEALING

§13.5.1 General Remedy—Rescission

As a general matter, an invalid self-dealing transaction is voidable at the election of the corporation—either in a direct action by the corporation or in a derivative suit. The general remedy is rescission, which returns the parties to their position before the transaction. Normally, the corporation cannot seek to "renegotiate" the terms of the transaction by retaining the transaction's benefits, but at a lower price. After all, a self-dealing transaction may provide value to the corporation, and a director who transacts with the corporation should not be exposed to the risk the corporation will use a fairness challenge to renegotiate the deal.

§13.5.2 Exceptions to Rescission

A rescission remedy does not always work—such as when self-dealing is also the usurpation of a corporate opportunity (that is, the taking of a valuable business opportunity in which the corporation has a preexisting interest or that is within its line of business), or when the property has been resold and is no longer held by the original party. In such cases, the corporation may be entitled to damages instead of rescission.

For example, in *New York Trust Co. v. American Realty Co.*, 155 N.E. 102 (N.Y. 1926), a director resold to the corporation at a significant profit timberland that he had purchased only a few months before. Although the transaction was voidable under the then-prevalent "fairness plus validation" test because the director dominated the board, the corporation chose not to rescind. The court, while stating that normally rescission is the exclusive self-dealing remedy, held the director could be liable for his profits on an "agency" (or "corporate opportunity") theory without the transaction being rescinded. The director was required to account for his profits and became liable as though he had acquired the timberland for the corporation.

Examples

1. Last year major league baseball approved an expansion team in Havana, Cuba—after the island's admission to the Union as the fifty-first state. The team (the "Cuba Libres") is incorporated in an MBCA jurisdiction that has adopted Subchapter F. The largest shareholder of the Libres is Silvio Garcia (40 percent); the remaining shares are held publicly, mostly

by rabid Cuban baseball fans. Garcia, the board chair and company CEO, hand-picked the other four directors: Alejandro (his brother-in-law), Bobby (a prominent Cuban politician), Camilo (a prominent Cuban businessman), and Duncan (the company's outside lawyer).

a. Salsa Services operates a successful food concession business on the East Coast and has bid to operate food and beverage concessions for the Libres. Alejandro is a director and 25 percent shareholder of Salsa. Any problem if the Libres accept the Salsa bid?
b. Garcia calls a board meeting to consider the Salsa bid. Only Camilo and Duncan attend the meeting. The Libres bylaws specify that three directors constitute a quorum at board meetings. Do the two constitute a board quorum?
c. Both Camilo and Duncan had been personally invited to join the Libres board by Garcia. Neither owns shares in the team. Are the two qualified to approve the Salsa contract?
d. The two directors adjourn their meeting to ask Garcia for information about other bidders seeking the concession business. Garcia attends their reconvened meeting, answers their questions, and joins Camilo and Duncan in approving the Salsa bid. Does Garcia's presence and participation affect the validity of the board's action?

2. Ibrahim, a Libres shareholder, has waited his whole lifetime for baseball in Cuba. When he learns of the Salsa contract, he shouts, "It's a sweetheart deal." Salsa's three-year contract calls for Salsa to make flat payments to the Libres of $20 million per year for the right to be the team's exclusive concessionaire.
   a. Ibrahim wants the Salsa contract invalidated. Assuming the bid was approved by the Camilo-Duncan committee, who should he sue and what will he have to show?
   b. Ibrahim discovers that Alejandro, though he disclosed his directorship and 25 percent interest, never disclosed to the committee his inside knowledge that Salsa would have agreed to pay $24 million per year. Does Alejandro's failure to disclose Salsa's reservation price nullify the committee's approval?
   c. Happieaux, another well-established food concessionaire and the only other bidder, had bid $14 million per year plus additional

royalty payments of $4 for each fan who attends Libres games during the season. The committee, however, estimated annual attendance on the low end—1.4 million fans, producing for Libres $19.6 million in royalties. It chose the Salsa bid. Does this information indicate the Salsa contract is valid?

   d. Ibrahim discovers an internal Libres study that projects attendance of 2.6 million, 2.8 million, and 3.0 million during the first three seasons. Garcia failed to disclose this study to the Camilo-Duncan committee. Does this invalidate the Salsa contract?

   e. The Camilo-Duncan committee eventually became aware of the internal attendance study, though not from Garcia. The committee decided nonetheless to take the lower Salsa bid. Does this invalidate the Salsa contract?

3. At the next Libres shareholders' meeting, the board submits a shareholder resolution to ratify the Salsa contract. The company's proxy statement fully sets forth the terms of the contract, describes Alejandro's 25 percent interest in Salsa, and states the "Salsa contract assures the company a fixed payment not dependent on attendance figures."

   a. With Garcia (40 percent) voting for the resolution, it is approved by 55 percent of the outstanding shares. Most of the public shareholders vote against it. What effect does this shareholder ratification have on Ibrahim's challenge to the contract?

   b. The Libres articles of incorporation provide:

      > Any conflict-of-interest transaction between the Corporation and any director (or entity in which any director is interested) is conclusively valid if approved by a vote of a majority of the outstanding Shares. The Shares of any interested director may participate fully in such a vote.

      Does this affect the outcome of Ibrahim's challenge?

   c. Assume Garcia did not vote and a majority of public shareholders ratified the Salsa contract, though their shares did not constitute a majority. Would this vote affect Ibrahim's challenge to the contract?

4. The court rules that shareholder ratification was defective because the proxy statement failed to disclose the Happieaux bid, thus making the Salsa transaction unfair to the Libres.

a. Ibrahim wants the court to modify the Salsa contract to conform to the payment schedule offered by Happieaux, which the court had found was fair. Will the court order Salsa to make these payments?

b. Ibrahim had also sued Camilo and Duncan, the disinterested directors who approved the Salsa contract. Are they liable for the damages the Salsa contract caused the corporation?

Explanations

1. a. Yes. The concession could be rescinded as a director's self-dealing transaction because of Alejandro's and Garcia's conflicting interests. Alejandro's 25 percent shareholding in Salsa creates a "beneficial financial interest" that in all likelihood "would reasonably be expected to influence his judgment." See MBCA §8.60(1)(i). Moreover, even though nephews are not related persons under Subchapter F (see MBCA §8.60(3)), if Garcia's relationship with Alejandro is such that he would gain financially because of his Salsa holdings, he might have a "beneficial financial interest … of such financial significance" as to cloud his judgment. See MBCA §8.60(1)(i).

   Subchapter F, though it specifies when a director's conflicting interest transaction is valid, does not specify when the transaction is invalid. Nonetheless, courts have scrutinized director self-dealing and would impose a heavy burden on Alejandro and Garcia to prove the procedural and substantive fairness of the transaction.

   b. Yes. Under Subchapter F, as under most modern statutes, a majority of disinterested directors (but not less than two) constitute a quorum for purposes of considering a self-dealing director transaction. MBCA §8.62(c). The MBCA and other modern statutes relax the quorum requirement for the approval of self-dealing transactions so these transactions can be considered without interested directors present, thus facilitating impartial review by the disinterested directors. If Camilo and Duncan are "qualified directors," they would constitute a quorum.

   c. Perhaps. It depends on whether Camilo (the Cuban businessman) and Duncan (the company's outside lawyer) are sufficiently disinterested and independent. If they are, the two would be fully capable—as a majority of qualified directors—to approve the self-dealing transaction, despite the absence of the other directors. MBCA §8.62(a).

If either Camilo or Duncan is interested or lacks independence, their action would fail under the MBCA safe harbor. MBCA §8.62(a) (at least two qualified directors). As the company's outside lawyer, Duncan might be disqualified in a variety of ways. If he or his law firm expects fees because of work connected to the Salsa deal, his financial interest in the transaction would constitute a "conflicting interest" under the statute. See MBCA §8.60(1). If Garcia "dominates" his activities as a director, perhaps because he feels beholden to him for continuing fees, his independence would be in doubt. This involves a factual assessment of motives and loyalties. As Justice Frankfurter once admonished judges, "[W]e should not be ignorant as judges of what we know as men." Nonetheless, Delaware courts have said that it is not conclusive merely because a director is selected by an interested director or controlling shareholder.

d. Yes, under the MBCA. The MBCA "safe harbor" for board action applies only if the qualified directors deliberate and vote "outside the presence of and without the participation by any other director." MBCA §8.62(a)(1). Other "interested director" statutes, however, are not as strict and specifically do not invalidate action by the board just because of the presence or participation of an interested director. See Del. GCL §144(a).

Even though the safe harbor is not available because of Garcia's presence and vote at the meeting, a court would still have to review the transaction for procedural and substantive fairness. The MBCA Official Comments define "fairness" as encompassing both "consideration and other terms of the transaction" and "process of decision the director's conduct." Official Comment, MBCA §8.60 ("fair to the corporation"). Among the fair dealing factors is whether the director exerted "improper pressure" on the other directors, presumably by being present and participating in the meeting at which the self-dealing transaction is considered.

2. a. Ibrahim should bring a derivative action (see Chapter 31) on behalf of the corporation and name the interested directors, Garcia and Alejandro, and the approving directors, Camilo and Duncan. Under Subchapter F the challenger must prove the director's conflicting interest and must establish that board approval (or any shareholder approval) was flawed. If he does, the directors then bear the burden to show the transaction

was fair. Failing this, the corporation can rescind the transaction. And the directors may be individually liable—the approving directors for their "lack of objectivity" under MBCA §8.31(a)(2)(iii), and the interested director for his "receipt of a financial benefit to which he was not entitled" under MBCA §8.31(2)(v). The business judgment rule would not apply, and there would be no presumption of validity.

b. Probably not. The Subchapter F safe harbor for self-dealing approved by disinterested directors requires that the interested directors disclose the "existence and nature of their conflicting interest" and all facts known to them about the transaction that an "ordinarily prudent person would reasonably believe to be material" to whether or not to proceed. MBCA §8.60(4) ("required disclosure").

   The duty to disclose *material* information puts the director in the uncomfortable position of a fiduciary and a self-interested counterparty. In this case, the discomfort is even greater for Alejandro, who owes fiduciary duties to Salsa not to disclose confidential information. The Official Comments to Subchapter F recognize this and suggest the director need not disclose all material information, but only that information the corporation would normally ascertain in an arm's-length negotiation. Thus, the director need not "reveal personal or subjective information that bears on the director's negotiating position." For example, the director need not reveal "the lowest price he would be willing to accept."

c. Probably. It may depend on the soundness of the committee's attendance estimates. The fixed Salsa price ($20 million) is slightly better than the variable Happieaux price ($19.6 million), if the committee's attendance estimates are valid.

   If the transaction was approved by a majority of qualified directors, there would be no further review under the current MBCA's safe harbor and the transaction could not be challenged. Instead, it would receive the business judgment presumption, requiring only that the decision was based on some rational business purpose. (An earlier version of the MBCA suggested that board approval of director self-dealing could be challenged if "manifestly unreasonable"—a standard less deferential than the business judgment rule, but more deferential than traditional fairness review.)

The current MBCA "safe harbor" approach is similar to that of Delaware under its nonvoidability statute. See *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114 (Del. 2006) (holding that Del. GCL §144 creates safe harbor, and thus protection of business judgment rule, for self-dealing transaction approved by informed, disinterested directors). The challenger carries the heavy burden to show something akin to waste.

d. Probably. The information would seem material, as it reveals that the variable contract (producing royalties of $24.4 million, $25.2 million, and $26.0 million) is superior to the fixed $20 million Salsa bid. Even though the interested Garcia's failure to disclose this study renders the Salsa contract unprotected by the safe harbor for disinterested director approval, a court could nonetheless conclude the contract was fair. That is, the board-approval safe harbor is not exclusive.

The fairness safe harbor of the MBCA, like judicial fairness review, contemplates judicial inquiry into the process of approval. Note on Fair Transactions, MBCA §8.61 ("course of dealing—or process—is a key component to a 'fairness' determination under subsection (b)(3)"). For example, the *Weinberger* "fair dealing" standard requires that the process of negotiation and approval of the self-dealing transaction conform to what would be expected of an independent board. See §17.3.3. This means the interested director should disclose all *material* information, and the approving directors may not be influenced by the interested director. Note on Fair Transactions, MBCA §8.61 ("most obvious illustration of unfair dealing arises out of the director's failure to disclose fully … hidden defects known to him regarding the transaction"). If the undisclosed attendance study would have added to information the board had on attendance estimates, it could be expected that Garcia would have disclosed it if he were not interested. As such, it is material and the board's approval does not insulate the transaction from review.

e. Not necessarily. If the committee's approval otherwise complies with the board-approval safe harbor, "neither the transaction nor the director is legally vulnerable" because of the director's conflict. See Official Comment, MBCA §8.61(b).

Even if the committee's approval failed to comply with the board-

approval safe harbor, the transaction might still be saved if shown to be "fair to the corporation." The burden would be on the interested directors to show not only that the terms of the deal are comparable to what would have been obtained in an arm's-length transaction, but also that the transaction was likely to yield favorable results for the corporation. The behavior of the interested director—such as incomplete disclosure, exertion of improper pressure, or an untoward role in negotiating the transaction—may also be relevant to the court's evaluation of the fairness to the corporation. See Official Comment, MBCA §8.60.

3. a. Very little. The resolution was not approved by a majority of shares held by disinterested shareholders. MBCA §8.62(a), (b) (safe harbor requires majority of "qualified" shares be cast for transaction; "qualified" shares are those not owned or controlled by the interested director). In fact, a majority of disinterested shares were cast against the resolution. The burden will fall on Garcia and the other defendants to show the transaction's fairness.

   b. Perhaps, but only mildly. The MBCA allows for the articles of incorporation to contain limits on the power of the board and shareholders. MBCA §2.02(b)(5). But the Libres provision would effectively gut judicial review of self-dealing if the interested director, as here, controls the proxy mechanism or holds a significant block of stock. Just as courts have been unwilling to read statutory provisions as displacing judicial review of self-dealing transactions, there should be judicial reluctance to give a broad exculpatory provision full effect. Perhaps, as has happened in some cases, the reviewing court would merely shift the burden of proof to the challenger to show unfairness.

   The ALI Principles permit corporate parties to preapprove self-dealing transactions in the articles, but this dangerous practice is limited to "specified types" of self-dealing transactions that "can be expected to recur in the company's ordinary course of business." ALI Principles §5.09(a). The carte blanche provision in the Libres articles would not be binding.

   c. Yes. Ibrahim would have to show some defect in the process of shareholder approval, such as a failure to disclose the terms of the competing Happieaux bid or to describe the internal study estimating

large attendance figures in the first three years. Like the board-approval safe harbor, shareholder approval must be accompanied by “required disclosure” of all material facts known to the interested director. MBCA §8.63(a). Absent a showing of some process flaw, the MBCA safe harbor provision treats the shareholder ratification as conclusive, without further judicial inquiry into the transaction’s merits. MBCA §8.63. This is a significant departure from the prevailing judicial approach in such cases to either shift the burden to the challenger to show unfairness or to show waste.

The failure of the disinterested shareholders to constitute a quorum is not a problem. The MBCA, like many other statutes, requires only a majority of disinterested shares to constitute a quorum. MBCA §8.63(c).

4. a. Probably not. The usual remedy for unfair self-dealing is rescission of the transaction. This assures the self-dealing insider that the corporation cannot unilaterally revise the terms of the transaction in a judicial fairness challenge. If the royalties are indeed inadequate, the solution is to rescind the Salsa contract and for the corporation to find a better contract, presumably based on the Happieaux bid. In smaller corporations self-dealing transactions may be uniquely valuable, offering business opportunities to the corporation not otherwise available on the open market. The rescission-only rule keeps courts out of the business of reforming private arrangements.

   b. Probably not. Because they were not interested in the transaction, they are liable only if they violated their duties of care. If they rationally believed that they were acting in the corporation’s best interests and sought to inform themselves about the Salsa contract, their liability for approving the contract is protected under the business judgment rule. See §12.3. They may also be shielded from personal liability under any exculpation provision in the corporate charter. See §12.5.

CHAPTER 14

Executive Compensation

Executive compensation is the most common form of corporate self-dealing. But the rendering of managerial services by corporate executives is also an indispensable corporate activity. For this reason, executive compensation receives special judicial deference. When approved by disinterested and independent directors, executive compensation receives deferential business judgment review.

This chapter describes the various forms of executive compensation (§14.1), the different standards of judicial review (§14.2), the treatment of directors' fees (§14.3), and recent market and regulatory activities (§14.4).

§14.1 FORMS OF EXECUTIVE COMPENSATION

Modern corporate executives are compensated *directly* in a number of ways:

- **Salaries and bonuses.** Base salaries and bonuses, usually set annually, represent compensation for current services.
- **Stock plans.** Stock grants, stock options, and other plans based on stock value create incentives for executive performance; their purpose is to

align management and shareholder interests by pegging compensation to the corporation's stock price.

A *stock grant* by the corporation provides the executive a shareholding stake in the business, but dilutes other shareholders' interests.

A *stock option* granted by the corporation gives the executive the option during a specified period (often in the future) to buy a specified amount of the company's stock at a fixed price (often set above the stock's current market price). If the market price for the company's stock rises above the option's exercise price ("in the money"), exercising the option becomes profitable. When the executive exercises a stock option, the executive receives company shares, thus diluting the shares held by other shareholders. If the market price does not rise above the exercise price ("out of the money"), no shares are issued and the corporation's capital is not diluted.

Phantom stock plans and *stock appreciation rights* provide similar incentives without the corporation having to issue any stock (or, for that matter, have any stock authorized in the articles). The executive is credited with units on the corporation's books, and the value of the units rises or falls with the market price of the company's stock (including dividends and stock splits). The units represent a form of deferred compensation, and their value is not paid until a specified date, such as retirement or death.

- **Pension plans.** Pension plans and other forms of deferred compensation provide executives' retirement income. Plans qualified under the Internal Revenue Code make it possible for the corporation to immediately deduct corporate contributions to the plan even though the executive is not taxed until later.

Executives also are compensated *indirectly* with fringe benefits (perks), such as expense accounts, company residences, contributions to charities designated by the executive, and the use of corporate jets.

Stock Options

Understanding the operation of stock options is basic to understanding modern executive compensation. Let's assume that ABC Corp. is a public corporation, its common shares trading at $15 per share. The corporation

grants stock options to its CEO, Martha, which give her the right (the option) to buy 5,000 shares at $15 per share after two years, but not beyond three years. This is like a lottery ticket for Martha; she wins if two to three years from now the stock price goes above $15.

Let's say the stock price after two years is $25. Martha can exercise her options and buy 5,000 shares from the company at $15, immediately reselling them in the market at $25 for a gain of $10 per share, or $50,000. Or Martha could hold on to the options (not exercise them) and hope the stock price rises even more before they expire in another year.

If, however, the stock price is only $12 after two years, Martha will not exercise the options, though they will still have value given the possibility that the stock price could go above $15 in the next year. But if the stock price stays flat, the options expire and she loses nothing—except her hopes for quick wealth.

Disclosure of Executive Pay in Public Companies

Under rules promulgated by the Securities and Exchange Commission (SEC), public companies must disclose in the company's annual proxy statement the compensation of their CEO, CFO, and three highest-paid executives. Exchange Act Schedule 14A (item 8), Reg. S-K, item 402 (see §§9.2, 9.3). Disclosure must be presented in tabular form covering the last three years of salary, bonuses, stock-based awards, nonstock incentive plan payments, retirement pensions, deferred pay, and perquisites. Any stock-based compensation must be presented as a dollar amount, reflecting the present value of any stock grants or stock options exercisable in the future, as well as amounts actually realized from stock-based awards. The table must then include a "total compensation" number.

In addition to disclosing this pay information, companies must discuss the objectives and implementation of their compensation programs (which the company's CEO and CFO must certify) and describe the process the board's compensation committee used to review and set the top executives' pay packages. Under the Dodd-Frank Act of 2010, public companies must also disclose the relationship between pay for the company's CEO and the company's financial performance. Dodd-Frank §953. Dodd-Frank also gives shareholders in public companies a "say on pay"—that is, the right to cast an *advisory vote* on the company's pay practices. Dodd-Frank §951. For example, shareholders can register their displeasure when there is a

disconnect between pay and performance—such as when executive pay is going up at a company while the company's stock price is going down. See § 14.4.3 below.

These SEC-filed disclosures are carefully scrutinized by the business press, which uses them to report annually on the highest-paid executives and "grade" their relative value. Activist shareholders and proxy advisory firms also use the disclosures to identify companies where there is excessive pay or pay unrelated to performance. Companies failing to receive majority "say on pay" support from their shareholders have often changed their pay practices, sometimes even retroactively.

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§14.2 JUDICIAL REVIEW

§14.2.1 Dilemma of Executive Compensation

Senior executives, particularly in public corporations, have significant sway over board decision-making. As a result, the board's setting of executive compensation raises many of the same concerns as are raised in director self-dealing transactions: (1) the executive predictably will prefer his own interests, and (2) the board will predictably accede to the executive's wishes, at the expense of corporate interests.

But treating executive compensation like any other self-dealing transaction would force courts to *regularly* place a value on a particular executive's services to the corporation, often without a working knowledge of the corporation, the particular value of the executive to the corporation, or the executive's market value to other corporations. Some commentators argue that judicial deference is warranted because most large corporations link executive pay significantly to corporate performance. Others, however, have looked at multimillion-dollar executive compensation packages and questioned the sufficiency of internal process and market limits alone. Board compensation committees, each trying to give "above average" compensation to their "above average" executives, have set into motion a seemingly boundless upward spiral in executive pay.

The accounting scandals of the early 2000s and the failures of risk management in the financial crisis of 2008 also raise doubts about creating incentives for executives (and other employees) with stock-based

compensation, particularly stock options whose value depends on the company's stock price rising above the options' exercise price. By linking compensation to a rising stock price, the corporation creates the perverse incentive for the executives to manipulate the stock price through accounting gimmicks or to engage in overly risky business strategies.

§14.2.2 Compensation Authorized

Executive employment contracts, like any other transaction with the corporation, must be properly authorized. The shares for stock-based compensation must be authorized in the articles. MBCA §2.02; Del. GCL §151(a). Transactions involving the corporation's stock (such as stock grants, options, or repurchases) require board approval. MBCA §6.24; Del. GCL §152. In addition, some statutes require that stock options be approved by shareholders when the options, if exercised, would result in a substantial dilution of existing shareholders. MBCA §6.21(f) (requiring shareholder approval if options can be exercised to acquire shares that will comprise 20 percent of the voting power of shares outstanding immediately before option grant); see also NYSE Listed Company Manual Rule 312.03 (same for companies listed on exchange).

The board, particularly in public corporations, often delegates the task of reviewing and approving executive pay to a compensation committee of outside directors. MBCA §8.25(d); Del. GCL §141(c). Whether a director interested in his own compensation can be counted for quorum purposes, or vote for his own compensation, raises the same questions as in other self-dealing transactions. Some statutes authorize approval by less than a quorum of directors if disinterested directors approve the compensation. See MBCA §8.62(a) (board action effective if director self-dealing transaction receives affirmative vote of majority ([at least two]) of qualified directors); Del. GCL §144(a)(1) (approval of director self-dealing transaction by disinterested directors, even less than quorum).

One recent practice that ran afoul of the requirement that stock-based compensation be properly approved was the backdating of options, where the exercise price was not set using the company's stock price on the grant date but instead an earlier date when the stock price was lower. Such "backdated" options were thus immediately more valuable to those holding them because of their lower exercise price. Courts had little trouble concluding that the

failure of compensation committees to follow the pricing rules of the company's stock option plans that had been approved by the board (and also the shareholders) was a violation of fiduciary duty, especially when the backdating was done in secret. See *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007) (finding that deliberate violation of shareholder-approved stock option plan and false disclosures rebut the business judgment rule and constitute bad faith, thus violating duty of loyalty).

§14.2.3 Disinterested Approval

Executive compensation is not subject to fairness review so long as it is approved by directors who are informed, disinterested, and independent. Stock listing standards for public corporations require that a majority of directors be independent (see §11.4); the listing standards, as mandated by Dodd-Frank, also require that all directors on the compensation committee be independent (see §14.4.4 below).

The board must be aware of all material information related to the executive's compensation, and the interested executive cannot dominate the board's decision-making. Courts have held that "back-scratching"—where officer-directors tacitly agree to approve each other's compensation, while each interested executive steps out of the meeting as his compensation is approved—does not satisfy the requirement of disinterested approval. See *Stoiber v. Miller Brewing Co.*, 42 N.W.2d 144 (Wis. 1950). But courts consider approval to be disinterested if nonmanagement (outside) directors or a committee of outside directors make compensation recommendations to the full board, even if the outside directors or committee constitute less than a quorum of the board and the full board is composed of a majority of inside directors.

In general, it is easier to muster *disinterested* board approval in a public corporation, where outside directors have become the norm, compared to a closely held corporation, where a majority of the board (if not the whole board) may have an employment relationship with the corporation. For this reason, compensation in a close corporation often turns on the approval or ratification by a majority of informed, disinterested shareholders. ALI Principles §5.03 (placing burden of proof on challenger to show waste if compensation approved by informed, disinterested shareholders).

Effect of Ratification

Over time, courts have changed their views on whether (and to what extent) approval or ratification by a majority of informed, disinterested shareholders affects judicial review. Some earlier cases, reflecting doubts about the informational efficiency of shareholder voting in public corporations, suggest that approval by informed, disinterested shareholders merely "freshens the atmosphere," and the burden falls on the directors to disprove waste. *Gottlieb v. Heyden Chemical Corp.*, 90 A.2d 660 (Del. 1952) ("possible indifference, or sympathy with the Directors, of a majority of the stockholders"). More recent cases, however, have concluded that shareholder ratification cleanses the transaction and shifts the burden to the shareholder challenger to show waste. *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997) (noting that in "this age in which institutional shareholders have grown strong," classic waste standard does afford some protection in egregious cases); *Harbor Finance Partners v. Huizenga*, 751 A.2d 879 (Del. Ch. 1999) (noting that if "fully informed, uncoerced, independent stockholders" approve compensation plan, "difficult to see the utility of allowing" plaintiff to prove compensation devoid of merit).

§14.2.4 Waste Standard

If executive compensation is approved by disinterested and independent directors, courts invoke the presumptions of the business judgment rule. One way the challenger can overcome the business judgment presumption is to show the compensation was a waste of corporate assets—that is, the compensation had *no relation* to the value of the services promised and was really a gift. See *Beard v. Elster*, 160 A.2d 731 (Del. 1960) (upholding approval by disinterested directors of stock options in "twilight zone where reasonable businessmen, fully informed, might differ"). Thus, for example, a post-death payment to an executive's widow not pursuant to any agreement lacks consideration and constitutes waste. *Adams v. Smith*, 153 So. 2d 221 (Ala. 1963).

The deference given disinterested and independent approval of executive compensation in a public corporation is illustrated by the much-litigated compensation paid the president and five vice presidents of American Tobacco during the Great Depression. *Rogers v. Hill*, 289 U.S. 582 (1933).

Under a bylaw adopted by American Tobacco shareholders in 1912, the executives received annual bonuses based on a percentage of the corporation's net profits above a stated base. As the company prospered, so did the executives. By 1930, with the Depression deepening and America smoking more, the president's annual bonus under the bylaw grew to $842,000 and each vice president's to $409,000—at a time when the average U.S. household income was less than $2,000 per year. Shareholders challenged the compensation as excessive under federal common law (before *Erie*). Although the amounts were staggering at the time, the Supreme Court gave "much weight" to the shareholders' near-unanimous approval of the bylaw and held that the bonuses could be challenged only if they were shown to be wasteful—that is, only if there was no relation between the bonus amounts and the executive services.

Even as executive compensation has lately spiraled upward, courts have honed close to the waste standard, dismissing complaints that the courts admit describe "exceedingly lucrative" compensation. Nonetheless, some cases suggest that allegations of wasteful compensation may raise factual questions that require further evidence. See *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997) (holding that "one time option grants to directors of this size" warrant the taking of evidence).

§14.2.5 Bad Faith Standard

Another way that a challenger can overcome the business judgment presumption—even when disinterested and independent directors have approved the compensation—is to show that the directors acted in bad faith. To show bad faith the challenger must show the directors "consciously disregarded" their duties in approving the compensation, either by not becoming informed or by engaging in a subterfuge or other deception of shareholders. For example, directors on a compensation committee violated their duty of good faith by approving executive stock options with an exercise price equal to the market price on the grant date when the directors knew that the company would be announcing favorable news soon after the grant date, causing the options to immediately rise in value. See *In re Tyson Foods, Inc*., 919 A.2d 562 (Del Ch. 2007). The court held that such "spring-loaded" options are inherently unfair when concealed from shareholders.

Disney and Good Faith

The ongoing litigation over a $140 million severance package paid by the Walt Disney Company to Michael Ovitz, hired from Hollywood in 1995 to be the company's number two executive, illustrates the courts' deferential approach to executive compensation. The case, which was filed in 1998, was originally dismissed despite the "sheer magnitude of the severance package." *In re The Walt Disney Co. Derivative Litigation (Disney I),* 731 A.2d 342 (Del. Ch. 1998). On appeal, the Delaware Supreme Court expressed concern about the "lavish" payout and the board's "casual, if not sloppy" review of the package, but affirmed the dismissal, with leave to amend. *Brehm v. Eisner,* 746 A.2d 244 (Del. 2000).

After the plaintiffs amended their complaint, based on new information gathered after a statutory inspection of the company's books and records, the Delaware Chancery Court took a different tack. Concluding that the allegations painted a picture of directors who "consciously and intentionally disregarded their responsibilities," the court set the case for trial. In a move that garnered much attention, the court suggested that the directors had breached their duty to "act honestly and in good faith"—leaving open the possibility that the company's exculpation provision under Del. GCL §102(b)(7) (see §12.5) would not shield the directors from personal liability. *In re Walt Disney Co. Derivative Litigation (Disney II),* 825 A.2d 275 (Del. Ch. 2003).

After a protracted trial, the court concluded that the directors had not breached their fiduciary duties, even though their conduct "fell significantly short of the best practices of ideal corporate governance." *In re The Walt Disney Co. Derivative Litigation (Disney III),* 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006). The chancery court concluded that enticing Ovitz to leave his high-profile position in Hollywood required making significant financial assurances if he were ever terminated. The failure of the directors to analyze the full ramifications of the pay package was "at most ordinary negligence." The court, however, hinted that the result might be different for a present-day pay package approved in "an era that has included the Enron and WorldCom debacles, and the resulting legislative focus on corporate governance."

§14.2.6 Fair and Reasonable Standard

When compensation has not been approved by informed, disinterested, and independent directors, it is subject to fairness review—and judicial scrutiny is substantial. The court takes on the function of the board (or compensation committee) and assesses whether the challenged compensation is fair and reasonable to the corporation, taking into account

- the relation of the compensation to the executive's qualifications, ability, responsibilities, and time devoted
- the corporation's complexity, revenues, earnings, profits, and prospects
- the likelihood incentive compensation would fulfill its objectives
- the compensation paid similar executives in comparable companies.

Full-fledged fairness scrutiny arises mostly for compensation in close corporations where boards (or committees) of disinterested directors are the exception. *Wilderman v. Wilderman,* 315 A.2d 610 (Del. Ch. 1974) ("standard for fixing executive compensation is obviously more strict when it is fixed by the recipient himself"). The scrutiny parallels that given executive compensation when the IRS challenges the deductibility of salaries as an "ordinary and necessary business expense."

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§14.3 DIRECTORS' COMPENSATION

§14.3.1 Directors' Fees

Originally, directors served without compensation. Their reward was the increased value of their shares. As public ownership of corporations grew and shareholdings of directors declined, directors came to be paid relatively modest fees for serving on the board and for each meeting they attended. Today, as outside directors have become more important, directors' fees have become significant—sometimes totaling up to $100,000 per year and often in the form of company stock, though not stock options given the excessive risk taking the latter induce. In addition, directors are compensated indirectly through expense reimbursement, directors' liability insurance (see §15.2), corporate travel, and even product discounts.

Directors' fees authorized by disinterested shareholders are reviewable

only if they constitute waste. See Official Comment to MBCA §8.61 (noting that director compensation, though universally accepted in principle, must be fair to the corporation or favorably acted on by shareholders). Even when directors' fees are not approved by shareholders, courts have been reluctant to intervene. See *Marx v. Akers,* 666 N.E.2d 1034 (N.Y. 1996) (dismissing claim that outside directors' increase of their own annual retainer to $55,000, plus 100 shares of company stock, did not constitute waste or "call into question whether the compensation was fair to the corporation").

§14.3.2 Compensation for Outside Services

Services provided by outside directors (or their firms) to the corporation—such as by lawyers, accountants, and bankers—are treated as self-dealing transactions subject to fairness review. For instance, if a lawyer sits on the board and her law firm provides legal services to the corporation, legal fees must be what would be obtainable in an arm's-length relationship and must be for services for which the corporation has a need.

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§14.4 REGULATORY AND MARKET PRESSURE

Over the last decade, executive compensation has been controversial. News stories and books have chronicled the exorbitant pay of many American CEOs. In the words of a corporate compensation expert hired by many large corporations, "CEOs get paid hugely in good years and, if not hugely, then merely wonderfully in bad years." Graef Crystal, *In Search of Excess: The Overcompensation of American Executives* (1991).

Over the past few decades, while inflation-adjusted pay for most workers has been stagnant, the pay for corporate CEOs has skyrocketed. In 2010 the median pay package for a CEO at an S&P 500 company was $7.5 million, compared to the average private sector employee's annual pay of $40,000. Thus, the ratio in 2010 between the pay of the average CEO and that of the average worker was about 185:1. This compares to a ratio of 24:1 in 1965, 125:1 in 1993, and 290:1 in 2001. This disparity in the sharing of the financial returns in large U.S. public corporations has been controversial—and various federal laws have been enacted in response.

§14.4.1 Securities and Tax Laws

During the 1990s, federal regulators responded to the public outcry against overpaid executives and sought to impose some discipline.

SEC Disclosure

In 1992 the SEC significantly revised its rules on disclosure of executive compensation in public companies. See §14.1. Although there was some hope that these disclosures would shame board compensation committees into reining in compensation excesses, the greater information fueled an upward spiral as companies sought to out-compensate each other.

The SEC has continued to tinker with its disclosure rules. See Exchange Act Rel. No. 54,302A (2006) (requiring new Compensation Discussion and Analysis section and summary compensation table, including a present dollar value for stock-based compensation). In addition, Dodd-Frank requires disclosure about the role of (and potential conflicts) involving executive pay consultants, as well as additional disclosures comparing CEO pay and the company's financial performance. See Dodd-Frank §§952, 953 (see §14.4.3 below).

Tax Deductibility

In 1993 Congress revised the tax laws to disallow corporate deductions for executive compensation to the CEO and four highest-paid executives in excess of $1 million per year. An exception is made for compensation based on performance goals (1) determined by a compensation committee composed solely of outside directors, (2) approved by shareholders after disclosure of material terms, and (3) certified by the compensation committee to have been met. See I.R.C. §162(m). The 1993 tax change induced companies to increase incentive compensation (particularly stock-based compensation) linked to the companies' market performance.

An interesting question that the tax-deducibility provision raises is whether a board of directors commits "waste" if it approves executive pay that is not tax-deductible. In 2013, the Delaware Supreme Court affirmed the dismissal of a claim of corporate waste where a board had approved a $130 million executive compensation package that lacked full tax deductibility. The court explained that executive pay was not reviewable as waste unless it were shown that the corporation had given "something away for free."

Freedman v. Adams, 58 A.3d 414 (Del. 2013) (holding that informed, independent directors had no duty to structure executive pay package to take advantage of corporate tax deduction).

§14.4.2 Sarbanes-Oxley Act

In 2002, responding to stories of management abuse in companies hit by scandal, Congress took aim at abusive compensation practices.

Prohibition of Loans to Insiders

Sarbanes-Oxley prohibits public companies from giving "personal loans" to directors and executive officers. Sarbanes-Oxley §402; Exchange Act §13(k). A limited exception is available for loans to insiders made in the normal course of the company's business, such as credit cards offered by a bank to its executives on the same terms as offered to other customers.

The federal prohibition, which displaces state law, has forced companies to reassess such common practices as travel advances, personal use of company credit cards, retention bonuses (reimbursable if the executive leaves), indemnification advances by the company (reimbursable if the executive ultimately is not entitled to indemnification), loans from 401(k) plans, and cashless exercise of stock options (where the company or a broker gives the executive a short-term loan so the executive can exercise the options and then repay the loan once he sells the underlying shares).

Escrow during SEC Proceedings

Sarbanes-Oxley authorizes the SEC to seek a judicial order for the escrow of "extraordinary payments" made to corporate executives pending the outcome of an investigation and any charges against them. Sarbanes-Oxley §1103; Exchange Act §21C(c)(3). A recent case interpreted "extraordinary payments" to include "restructuring payments" of $37.6 million made to a company's CEO and CFO after they resigned their corporate offices to become "employees" of the company. *SEC v. Yuen*, 401 F.3d 1031 (9th Cir. 2005). The court determined the termination payments were "extraordinary" given both the unusual circumstances surrounding their approval (they were made after allegations that the company had overstated its revenues) and their relative size (they were five to six times larger than the executives' base salary in the previous year).

SEC Clawbacks of Incentive Pay

Under Sarbanes-Oxley, if a public company is required to restate its financial statements as a result of "misconduct," the company's CEO and CFO must reimburse the company for any incentive pay (such as bonuses or equity-based compensation) received from the company during the 12-month period after the misstated financials were issued or filed. Sarbanes-Oxley §304; 15 U.S.C. §7243. The provision raises a variety of uncertainties—not the least of which is whether the reimbursement action may be brought only directly by the company, or indirectly in a derivative suit, or through an enforcement action by the SEC. Also unclear is what constitutes misconduct and whether the CEO or CFO subject to reimbursement must have actually engaged in the misconduct.

Lower courts have held that §304 does not imply a private cause of action, but can be enforced only by the SEC. See *Cohen v. Viray*, 622 F.3d 188 (2d Cir. 2010). In the years following the adoption of §304, the SEC was criticized for not bringing any actions to enforce the clawback remedy. But beginning in 2009, the agency began to seek clawbacks from company executives under §304, including in cases where they were not personally involved in the misconduct that led to the financial restatements.

§14.4.3 Dodd-Frank Act

The Dodd-Frank Act again addressed the issues of executive compensation in public companies, responding especially to the public outcry against what was perceived as excessive executive pay at financial firms receiving government bailouts during the financial crisis of 2008. The Dodd-Frank reforms primarily focus on increased disclosure and greater shareholder input in pay practices.

"Say on Pay"

One of the most important contributions of Dodd-Frank is to provide shareholders an advisory (nonbinding) vote on executive pay in public companies. See Dodd-Frank §951(a) (adding Exchange Act §14A). Companies must include on the proxy ballot a chance for shareholders to vote for or against the pay packages of the company CEO and the four other top-paid executives. The vote must take place at least every three years, though

companies (as most have) can opt to make the vote annual.

In the first years of "say on pay," most companies have received more than 90 percent support for their pay packages, but when companies have received weaker support, especially when they received less than majority support, company boards often revised pay packages and even reduced pay retroactively. In addition, many of the handful of companies receiving negative "say on pay" votes have been sued. Shareholders have claimed that the directors failed in their fiduciary duties or engaged in corporate waste. Most of the suits have been dismissed, but some have withstood motions to dismiss. Although "say on pay" has not unleashed a revolution in executive pay practices, as some proponents had hoped, it has resulted in a new dynamic in shareholder-management relationships.

Golden Parachutes

Dodd-Frank also gives shareholders an advisory vote on executive pay packages arising in mergers or other corporate acquisitions. Dodd-Frank §951(b) (adding Exchange Act §14A). Whenever shareholders are asked to approve an acquisition, the company must also provide full disclosure of any special pay arrangements for departing company executives, such as "golden parachutes" (see Chapter 34). Thus, shareholders have a chance to voice their displeasure if executives in a poorly performing company receive a windfall for having mismanaged the company.

Company Clawbacks of Incentive Pay

Seeking to strengthen and expand the clawback remedy adopted in Sarbanes-Oxley (see §14.4.2 above), Dodd-Frank mandates that exchanges *require* listed companies to adopt procedures to recover up to three years of incentive pay from the company's executives (both current and former) whenever the company is forced to restate its financials. Dodd-Frank §954 (adding Exchange Act §10D). The new approach covers more executives than just the CEO and CFO; it expands the clawback period from one year to three years; it applies to all restatements, not just those due to misconduct; but it requires a clawback only of incentive-based pay that exceeds what would have been paid under the restatement. If the company fails to seek a clawback, the SEC can bring an action against the corporation to enforce the recovery, though (as with §304) there is no express private cause of action. As of 2014, most public companies had adopted clawback policies, even though the SEC had

not yet promulgated new clawback rules as required under Dodd-Frank.

Compensation Disclosure

Dodd-Frank adds new disclosures to the proxy statement. First, it requires that companies show "the relationship between executive compensation actually paid and the financial performance of the issuer." Dodd-Frank §953(a) (adding Exchange Act §14(i)). The disclosure of "pay versus performance" mirrors the growing view among shareholders that executives not reap rewards while their company fails. For example Kerry Killinger (the former CEO of Washington Mutual) was paid $25.1 million during 2008—the year that Washington Mutual collapsed under the weight of its ill-advised subprime mortgage exposure, was seized by the federal government and sold to JPMorgan for a fraction of its book value, and then filed for Chapter 11 bankruptcy.

Dodd-Frank also requires companies to determine and disclose (1) the total median compensation of all employees with the exception of the CEO, (2) the total compensation of the CEO, and (3) and the ratio of these two numbers. Dodd-Frank §953(b) (requiring the SEC to amend Item 402, Reg. S-K). The ratio, it has been said, can easily be manipulated by companies that outsource many low-level tasks, thus ensuring than non-CEO employee pay is relatively high and the ratio relatively low.

Finally, Dodd-Frank requires that the annual proxy statement include information on whether company officials are allowed to hedge any decrease in the company's securities—and thus bet against the company's financial performance. Dodd-Frank §955 (adding Exchange Act §14(j), requiring the SEC to issue rules).

§14.4.4 Shareholder Activism

Institutional shareholders also have targeted companies with high executive compensation compared to performance. Activist shareholders have used the SEC's shareholder proposal rule to urge compensation reforms (see §9.4.2), and institutional shareholders and proxy advisory firms have become increasingly involved in direct discussions with boards and compensation committees on pay issues. Proxy advisory firms, which advise institutional investors on exercising their voting rights, have created templates of acceptable terms in compensation plans—such as the ways that pay packages

should ensure that executives are not paid for failure or the repricing of "out of the money" options. Compensation committees must be sure their plans satisfy these templates.

In addition, the advisory "say on pay" votes by shareholders—required by Dodd-Frank in all public companies beginning in 2011—have led companies, particularly those that have received negative votes for their pay practices, to amend their pay packages to match pay with performance and to provide clearer disclosure to shareholders on how pay is consistent with shareholder interests. Companies that have received negative votes have also been subject to shareholder suits against directors, alleging violations of fiduciary duties for approving (unpopular) pay packages.

Examples

1. More Parking Corp. (MPC), incorporated in Delaware, is in the glamorous business of owning and operating parking garages. Leonard More, the company's founder, is board chair, company president, and a 30 percent shareholder. The remaining shares are publicly held; no other shareholder holds more than 5 percent.
   a. More's three-year executive compensation contract is coming up for renewal. The MPC board is composed of seven directors: More, three company executives, and three nonmanagement outside directors. Advise the board on how approval of the contract should be handled.
   b. Would you recommend the board seek to have shareholders ratify the contract?
2. The MPC forms a compensation committee of three outside directors, who approve a five-year compensation package for More of $400,000 in annual salary and a bonus of 5 percent of net earnings. The committee knows the package is generous. At current earnings levels, More will make $650,000 each year, compared to the $200,000 per year that top executives in the parking garage industry are paid.
   a. Cheryl, a long-time MPC shareholder, is outraged and wants to challenge More's compensation. She brings a derivative suit. What must she allege?
   b. Is there other action she can take?
3. The compensation committee, at More's request, also provided for his

retirement. After the three-year contract term, More can retire from the company and, by making himself available exclusively to the company, receive a guaranteed annual consulting fee of $400,000 a year, whether or not he actually performs consulting services.

a. Cheryl is even more irritated when she learns of the consulting arrangement. Will she succeed if she challenges the consulting arrangement as a waste of corporate assets?

b. The directors are worried about Cheryl's challenge. How might they change the consulting agreement to bolster its validity?

Explanations

1. a. Most lawyers advise the board to delegate the task of reviewing and negotiating the contract to a committee of directors, all of whom are nonemployee outside directors. This structure will avoid any claim that management directors set his compensation under a "back-scratching" arrangement where each director tacitly agrees to support each other's compensation. It will also avoid uncomfortable disclosure of committee conflicts under SEC disclosure rules. The committee should have access to all information about More and the company and should hire its own compensation consultant to provide pay information on comparable executives. It would be advisable that More not be present when the committee deliberates in order to avoid the appearance that he dominated or controlled the committee. If approved by directors who are informed, disinterested, and independent, More's compensation will be reviewable only under a forgiving waste standard.

b. Probably. Under Delaware law, even if board approval is found to have been misinformed or tainted, shareholder ratification has a cleansing effect and shifts the burden to the plaintiffs to show waste. *Lewis v. Vogelstein*, 599 A.2d 2 (Del. Ch. 1997).

Federal tax laws change the calculus for submitting pay packages for shareholder approval, particularly executive compensation above $1 million per year. Shareholder approval of performance goals is necessary for such compensation to be deductible. Although prior practice had been to submit only stock plans (authorization in the articles) for shareholder authorization, modern boards now regularly submit executive compensation plans for shareholder approval.

2. a. She must make allegations that rebut the business judgment presumption—a nearly insuperable standard. There are several possibilities suggested by the facts: (1) the directors failed to become informed, (2) the directors failed to act in good faith, (3) the directors were dominated by the interested director, or (4) the compensation was wasteful. If there were factual support, Cheryl might also allege that the compensation was specifically forbidden in the articles of incorporation or the compensation was illegal.

Cheryl might first allege that the committee failed to become informed about comparable pay in violation of its duty of care. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (see §12.3.3). Although a showing of gross negligence will support an injunction against the improperly approved pay, the committee members would not be individually liable for any damages to the corporation if the corporation has an exculpation proviso as provided by Del. GCL §102(b)(7) (see §12.5).

Next Cheryl might allege that the committee failed to act with good faith. If the committee approved the pay package, while consciously disregarding whether it was justified in light of comparable pay for comparable services, it would violate its duty of good faith. See *In re Walt Disney Co. Derivative Litigation (Disney II)*, 825 A.2d 275 (Del. Ch. 2003). Not only would the pay package be voidable, but the committee members could be individually liable because any exculpation cannot cover acts not in good faith. Del. GCL §102(b)(7) (see §12.5).

Next Cheryl might allege that More "dominates" the outside directors by virtue of his position as chairman and 30 percent stock owner—rendering the directors not independent and their approval a loyalty breach. "Domination" is a slippery and highly factual standard. Courts have held that generalized allegations of share ownership and position on the board are insufficient to establish domination. See *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (essentially the facts of this example). Instead, Cheryl would have to show the directors acted as requested without independent judgment.

Finally, Cheryl might allege the compensation is a waste of corporate assets—that is, no reasonable business person would say that

the compensation had any relation to the services received and that it was in reality a gift. *Lewis v. Vogelstein*, 599 A.2d 2 (Del. Ch. 1997). Mere allegations of a discrepancy between the compensation and pay to comparable executives, though sufficient under a fairness standard, would not be enough. The committee (and More) could defend the compensation by pointing to his experience with the company and other possibly unique attributes. Courts are reluctant to become involved in these matters of business judgment.

b. Cheryl might submit a shareholder proposal on executive compensation to be included in the company's proxy statement. Under Rule 14a-8, the proposal cannot demand the directors set a given pay, but can make precatory (advisory) recommendations or ask for the compensation committee to report on why More's compensation is more than three times higher than that of comparable executives. In 1992 the SEC changed course and now considers shareholder proposals on executive compensation to be includable under the rule.

3. a. Probably not. Cheryl would argue the consulting fee, by its terms, is unrelated to any services to the corporation. She could assert that there is no assurance More will actually provide the services; there is no indication the corporation will actually consult him; and whatever services he provides will be of little value and would be available from other sources for less money.

Despite these arguments, Cheryl will have an uphill fight. The directors (and More) can argue that his consulting services are unique and his *exclusive availability* will have great value to the corporation. Although outside consulting services can often be purchased for less than inside executive employment, courts have recognized the value of building up institutional knowledge and intuition. In addition, even if the consulting pay is argued to be unrelated to actual consulting services, it can be seen as deferred compensation for the five-year employment contract. Similar challenges to a comparable executive compensation package failed to impress the Delaware Supreme Court. See *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

b. The compensation committee could provide that the consulting fee is contingent on More's agreement not to compete with the corporation. The committee should also make clear that the consulting fee is not

necessarily related to future services, but rather to the noncompete agreement or the five-year contract. Courts have invalidated compensation tied to future services where there was no assurance the services would be performed.

CHAPTER 15 Indemnification and Insurance

In our litigious society, being a corporate official is risky business. Corporate directors and officers can be named in private lawsuits brought by shareholders, third parties, or in governmental proceedings challenging corporate behavior. To encourage qualified individuals to accept corporate positions and take good-faith risks for the corporation, corporate statutes permit (and sometimes mandate) the corporation to indemnify directors and officers against liability arising from their corporate position (§15.1). Directors' and officers' (D&O) insurance supplements this protection (§15.2).

Indemnification and insurance represent two of the legs of the four-legged stool on which directors sit. The other two are the protection under the business judgment rule (see §12.2) and liability exculpation authorized by corporate statutes, such as Del. GCL §102(b)(7) (see §12.5).

§15.1 INDEMNIFICATION— CORPORATE REIMBURSEMENT

What is corporate indemnification? It is simply the corporation's reimbursement of litigation expenses and personal liability of a director sued because she is or was a director. (Indemnification of officers and other

corporate agents is similar and is discussed below.) In general, indemnification applies when the director is or was (or is threatened with being made) a defendant in any civil, criminal, administrative, or investigative proceeding. A director's indemnification rights continue even after she has left the corporation.

Open-ended corporate indemnification undermines directorial accountability under corporate law and other noncorporate regulatory schemes. For example, if directors could act with impunity to authorize the corporation to deceive investors or dump toxic chemicals, confident they would be held harmless if ever sued, the deterrent effect of personal liability under the securities and environmental laws would be undermined. Moreover, if the corporation indemnifies directors who breach their fiduciary duties to the corporation, the compensation and deterrence goals of fiduciary liability are effectively nullified.

Because of indemnification's potential to frustrate other goals and policies, a director's right to indemnification and the power of the corporation to indemnify depend on whether

- the director was successful in defending the action or
- the director, though unsuccessful in her defense, was justified in her actions (for example, by seeking in good faith to promote the corporation's interests in a legally ambiguous situation).

Generally, indemnification rights are fixed by contract or the corporation's constitutive documents (articles of incorporation or bylaws). See MBCA §2.02(b)(5) (permitting indemnification in articles of director's conduct to same extent corporation can exculpate liability for such conduct). Statutory indemnification provisions provide the framework for drafting, interpreting, and enforcing contractual indemnification rights. See MBCA Chapter 8, Subchapter E, §§8.50-8.59; Del. GCL §145.

Note on Indemnification of Nondirectors

In general, the corporation may indemnify nondirector officers, employees, and agents to the same extent as directors. MBCA §8.56

(official comment that corporation has power to indemnify employees and agents); Del. GCL §145(a). Indemnification of officers (though not others) is mandatory to the same extent as if the officers were directors.

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§15.1.1 Mandatory Indemnification for Successful Defense

If a director is sued because of her corporate position (such as for approving a corporate decision or issuing a corporate statement) and she defends successfully, the corporation is *obligated* under all state statutes to indemnify the director for litigation expenses, including attorney fees. MBCA §8.52; Del. GCL §145(c). The right of the successful director to claim repayment of expenses is available whether the suit was brought on behalf of the corporation or by an outside party.

The right protects a director from the corporation's faithless refusal to indemnify a director who successfully defends a suit arising from her corporate position. Cf. Restatement (Second) of Agency §438 (requiring principal to indemnify agent whenever agent "suffers a loss which, because of their relation, it is fair that the principal should bear"); *New York Dock Co. v. McCollum*, 16 N.Y.S.2d 844 (Sup. Ct. 1939) (holding directors are not "agents" of corporation and thus not entitled to indemnification as would be the case for employee).

A director's statutory right to mandatory indemnification raises two issues: (1) When is a defense successful? (2) Can there be mandatory indemnification for a partially successful defense?

Success "on the Merits or Otherwise"

Corporate statutes uniformly require indemnification when the defendant is successful "on the merits," such as when the suit is dismissed for lack of evidence or on a finding of nonliability after trial. MBCA §8.52; Del. GCL §145(c). Under most statutes, success can also be on procedural grounds—success "otherwise"—such as when a suit is dismissed because the plaintiff lacks standing or the statute of limitations has run. MBCA §8.52; Del. GCL §145(c). A director, however, is not deemed successful if the claim is settled out of court.

Indemnification "to the Extent" Successful

Some statutes (including some in Delaware) require indemnification "to the extent" the director is successful, compelling the corporation to reimburse a partially successful director's litigation expenses related to those claims or charges she defends successfully. Del. GCL §145(c).

In *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138 (Del. 1974), the Delaware Supreme Court interpreted a statute that required indemnification if the director was successful "in defense of any claim, issue or matter therein" as requiring indemnification for partial success. In the case, a director charged with five criminal offenses pleaded "no contest" to one on the condition the others were dropped. The court held he was entitled to indemnification as a matter of right for the litigation expenses related to the charges that were dropped. See also *Waltuch v. ContiCommodity Services, Inc.*, 88 F.3d 87 (2d Cir. 1996) (applying Delaware law to require indemnification of litigation expenses incurred by director charged with conspiring to corner silver market, after company ([but not director]) paid to settle private lawsuits brought by silver traders).

The *Merritt-Chapman* interpretation, it has been argued, permits undeserving directors to negotiate dismissals or plea bargain away most of the claims against them and become entitled to indemnification for the bulk of their litigation expenses. For this reason, some statutes make mandatory indemnification "all or nothing" and limit it to defendants who were "wholly successful." MBCA §8.52.

§15.1.2 Permissive (Discretionary) Indemnification for Unsuccessful Defense

Indemnification is not automatic when a director becomes liable because of his corporate role. Instead, corporate indemnification of an unsuccessful director's litigation expenses and liability is discretionary. The corporation may indemnify an unsuccessful director only if indemnification is approved by certain corporate actors or a court, under specified criteria. Under modern statutes the ability of the corporation to indemnify depends on whether the action was brought by a third party or was brought on behalf of the corporation.

Third-Party Actions

In an action brought by a third party—such as when the EPA sues for illegal dumping or investors claim securities fraud—the unsuccessful director must be deserving to be entitled to indemnification.

- **Indemnification criteria.** Many statutes permit corporate indemnification arising from third-party actions only if the director (1) acted in good faith (that is, the director did not know her conduct was illegal and did not act for improper personal gain), and (2) reasonably believed her actions were in the corporation's best interests. MBCA §8.51(a)(1) (or not opposed to corporation's best interests, if director acted in unofficial capacity, such as a representative to a trade association); Del. GCL §145(a). In a criminal proceeding, the director may have had no reasonable cause to believe that her actions were unlawful—a standard that goes beyond good faith. MBCA §8.51(a)(2); Del. GCL §145(a).

  Often the findings implicit in a final court judgment (or administrative order) against a director will be inconsistent with a finding that the director satisfied these criteria. A director increases her chances of permissive indemnification by settling or plea bargaining. Most statutes cooperate and state that a judgment, order, settlement, or no contest plea is not conclusive as to whether the director meets the criteria for indemnification. MBCA §8.51(c); Del. GCL §145(a).
- **Coverage.** A director sued in a third-party action may be indemnified for reasonable litigation expenses and any personal liability arising from a court judgment, an out-of-court settlement, or the imposition of penalties or fines. MBCA §§8.51, 8.50(4), (5); Del. GCL §145(a).
- **Procedures.** Statutes specify who must determine whether a director meets the criteria for permissive indemnification: directors who are not parties to the proceeding, a committee of nonparty directors, independent legal counsel appointed by nonparty directors, or disinterested shareholders. MBCA §8.55(b) (permitting legal counsel to determine if director meets criteria, but not actual amount of indemnification); Del. GCL §145(d). An internal finding that a director is entitled to indemnification is not conclusive, but is subject to judicial review. See *In re Landmark Land Co.*, 76 F.3d 553 (4th Cir. 1996)

(applying California's indemnification statute to reverse decision by independent directors to indemnify directors because illegal avoidance of federal S&L regulation could not constitute "good faith").

Actions by or on Behalf of the Corporation

Most statutes do not allow the corporation to indemnify a director "adjudged liable" to the corporation if the action is brought by the corporation itself or by shareholders in a derivative action on behalf of the corporation. MBCA §8.51(d)(1); Del. GCL §145(b). Allowing indemnification would create the absurdity of the corporation receiving payment from a culpable director with one hand and reimbursing the director with the other. This circularity would gut the effectiveness of directorial accountability.

Nonetheless, the corporation can indemnify a director who *settles* a suit brought against her by or on behalf of the corporation for her *litigation expenses* if she meets the criteria for permissive indemnification. MBCA §8.51(d)(1); Del. GCL §145(b) (reasonable expenses indemnifiable if director meets standard of conduct). In addition, a court (as opposed to the corporation) can order indemnification of litigation expenses, if fair and reasonable, even though the director is found liable in a derivative suit. MBCA §8.54(a)(3); Del. GCL §145(b). The MBCA even permits a court to order indemnification of settlement amounts in a derivative suit, if fair and reasonable. MBCA §8.54(a)(3). In each situation, the idea is that well-meaning directors should be protected from the full brunt of their litigation exposure.

Court-Ordered Indemnification

Even if the corporation refuses to (or cannot) indemnify a director under its discretionary authority, some statutes allow a court to order indemnification (of expenses and liability) of an unsuccessful director who the corporation determines does not meet the criteria for permissive indemnification. MBCA §8.54(a). But if the director is adjudged liable to the corporation or is adjudged to have acted for personal gain, the court can only order indemnification of the director's litigation expenses. MBCA §8.54(a)(3).

§15.1.3 Advancement of Litigation Expenses

The promise of eventual indemnification of litigation expenses after a successful defense may be empty if the director cannot pay for a full defense out of his own pocket. For this reason most statutes allow the corporation to advance litigation expenses during the proceeding. MBCA §8.53; Del. GCL §145(e). When the advances are made, it will not be known whether the director ultimately will be successful or be entitled to permissive indemnification, and the statutes impose varying conditions for advancing expenses. In addition, there is some question under the Sarbanes-Oxley Act whether an advancement of expenses constitutes a prohibited executive loan. Exchange Act §13(k) (see §14.4).

For a director to receive an advancement, the MBCA requires the director to (1) affirm his good-faith belief that he would be entitled to permissive indemnification or indemnification under a charter provision, and (2) undertake to repay the advances if he is not entitled to indemnification. MBCA §8.53(a); cf. Del. GCL §145(e) (requiring only repayment undertaking). Under the MBCA, the corporation acting through disinterested directors or shareholders must then authorize the advancement of expenses, subject to the standards that apply to board action. Official Comment to MBCA §8.53 (board cannot authorize advance if there are "red flags" indicating director not entitled to indemnification); cf. Del. GCL §145(e) (no specification of who must authorize advancement).

Under the MBCA, a director need not give security for his repayment obligation. To avoid discriminatory treatment against directors of modest means, the corporation can accept the repayment obligation "without reference to the [director's] financial ability to make repayment." MBCA §8.53(b). In Delaware two factors are relevant for authorizing advancement: (1) the likelihood the defendant will reimburse the corporation if indemnification is determined to be inappropriate and (2) whether the advancement would serve the interests of the corporation. *Advanced Mining Systems v. Fricke*, 623 A.2d 82 (Del. Ch. 1992).

Advancement is discretionary. The corporation can bind itself by contract (in an agreement, the bylaws, or even the articles) to provide advancement, or can make an advancement on an ad hoc basis. Under the MBCA, a corporation that obligates itself to indemnify a director "to the fullest extent permitted by law" must advance expenses, including in derivative suits, unless the provision specifies a limitation. MBCA §8.58(a). But when the corporation has not bound itself to provide advancement, a corporation's

decision not to advance expenses is discretionary and evaluated according to the business judgment rule.

§15.1.4 Exclusivity of Statutory Indemnification

Many statutes make the statutory indemnification provisions and procedures exclusive. Indemnification pursuant to the articles of incorporation, the bylaws, or an agreement is permitted only to the extent consistent with the statute. See MBCA §§8.58(a), 8.59. These statutes require a specific, case-by-case determination that the director is entitled to permissive indemnification or advancement of expenses. Official Comment to MBCA §8.58(a) (compliance with disinterested authorization "still required"). It is not enough that an employment agreement or the articles or bylaws contain a blanket indemnification clause.

Nonetheless, other statutes permit the corporation to indemnify directors under provisions in the bylaws or in a contract even though the statute does not contemplate it. Del. GCL §145(f). The indemnification procedures applicable under these extrastatutory provisions govern, provided they are consistent with "public policy." See *VonFeldt v. Stifel Fin. Corp.*, 1999 Del. Ch. Lexis 131 (interpreting Del. GCL §145(a) to require that director seeking indemnification under bylaw provision has acted in "good faith," though placing burden on corporation to show lack of "good faith"). Among other things, this means that the corporation cannot indemnify a director for liability to the corporation—because of the circularity problem.

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§15.2 INSURANCE

Corporate statutes permit the corporation to buy insurance for itself to fund its own indemnification obligations and for directors to fill the gaps in corporate indemnification, principally when a director is liable to the corporation in a derivative suit.

§15.2.1 Insurance Covering Corporation's Obligations

Indemnification is a form of insurance provided by the corporation to its directors, officers, employees, and other agents. The corporation can meet its indemnification obligations, statutory or extrastatutory, either by acting as a self-insurer or by purchasing insurance from outside insurance companies.

§15.2.2 Insurance Covering Liability of Directors and Officers

To supplement indemnification and to cover liability to the corporation, the corporation also can purchase liability insurance for its directors and officers —*D&O insurance*. Premium payments for such policies constitute additional executive compensation and are authorized either as such or by specific statute. MBCA §8.57; Del. GCL §145(g). Many statutes authorize the purchase of insurance even if it covers expenses and liability the corporation could not indemnify. MBCA §8.57; Del. GCL §145(g). Although it might seem anomalous that the corporation can indemnify indirectly through insurance what it is prohibited from indemnifying directly, the theory is that the director herself could have bought insurance, and it should not make any difference that the corporation compensates her by paying the premiums.

Usually, the corporation submits the D&O application and pays the premiums in the name of the insured executives. D&O policies typically cover any liabilities or defense costs arising from the executive's position with the corporation. The policies typically exclude coverage for

- improper personal benefits (such as self-dealing)
- actions in bad faith (including dishonesty)
- illegal compensation
- libel or slander
- knowing violations of law
- bodily injury/property damage
- pollution
- other willful misconduct

Many policies also exclude coverage for fines and penalties (including punitive damages) regardless of the executive's intentions. The effect of the exclusions is to make D&O insurance sometimes less encompassing than

indemnification by the corporation.

Examples

1. Jones, a shareholder of Trans Combo Corporation, sues the company's directors for failing to approve a merger for $55 per share with the Harmon Group, at a time the company's stock was trading at $38. Jones brings a derivative suit claiming the board failed to become informed about the Harmon bid and did not negotiate vigorously. Jones seeks damages from the directors. The Trans Combo board appoints a special committee composed of three directors who recently joined the board and Jones did not sue. The committee is authorized to decide all indemnification issues. Assume Trans Combo is incorporated in an MBCA jurisdiction.
   a. The director-defendants consider settling with Jones for $62 million —$5 per share. Must Trans Combo reimburse them for this settlement amount? Can Trans Combo reimburse them?
   b. If the director-defendants settle, must Trans Combo reimburse them for their litigation expenses? Can Trans Combo reimburse them?
   c. The defendant-directors reject the settlement offer, but ask the special committee to advance them money to pay for their mounting defense costs. Can Trans Combo pay the defendants' litigation expenses?
   d. The special committee concludes the directors acted in good faith and with the best interests of the company in mind when they rejected the Harmon bid. The committee nonetheless decides not to advance the directors' litigation expenses. Can it?
   e. The directors go to trial. The court decides the directors violated their duty of care by rejecting the merger without sufficient information, but are not liable for failing to negotiate vigorously. The defendant-directors seek repayment of their expenses related to their successful defense of the disclosure claim. Are they entitled?
2. Eventually, the directors settle with Jones and pay a significant settlement. Trans Combo has a typical directors' and officers' insurance policy with Concord Insurance Company. The policy period covers the claim brought by Jones.
   a. Does the D&O policy cover the settlement payments?

   b. Does the D&O policy cover the directors' litigation expenses?
   c. Orkin, Trans Combo's CEO, lied to the directors about the worth of the merger, which he wanted to avoid no matter what. Can Orkin seek indemnification under the D&O policy?
3. The Trans Combo directors get a second chance. The Harmon Group again offers $55 a share, and this time the directors accept. Trans Combo merges into New Trans Combo, a Harmon subsidiary. There is no pleasing Jones, who brings a class action in which he claims the directors were uninformed of the company's value, which he says is $65 per share.
   a. The directors again want to settle. Must New Trans Combo indemnify them for any settlement amounts? Can New Trans Combo indemnify?
   b. The bylaws of Old Trans Combo stated "each director is entitled to indemnification for losses because he is or was a director, if he acted in good faith and with a reasonable belief his conduct was in the best interests of the corporation." Is New Trans Combo obligated to pay for the directors' settlement?
   c. New Trans Combo makes significant payments to legal counsel to defend the directors. Must these payments be disclosed?
4. When the Harmon Group approached Trans Combo the first time about a merger, Orkin secretly bought Trans Combo stock on the market. He held on to the stock and eventually realized a hefty premium when the merger finally happened. The SEC sued him for insider trading (see §29.5), but was unable to show liability.
   a. Must New Trans Combo pay Orkin's defense costs?
   b. If New Trans Combo indemnifies Orkin, can it make a claim under Old Trans Combo's D&O insurance policy?
5. New Trans Combo hires Orkin to run the company. Orkin wants an indemnification agreement before he accepts. Draft one.

Explanations

1. a. Trans Combo is neither required nor permitted to indemnify directors for the amounts they pay in settling a derivative claim. Mandatory indemnification is available only for the expenses related to a successful defense. MBCA §8.52. Permissive indemnification is not available for

amounts in settlement paid by directors. MBCA §8.51(d)(1). Otherwise, the corporation would be collecting from the directors in the suit and repaying them through indemnification, and the deterrent and compensation purposes of derivative litigation would be frustrated. See Official Comment, MBCA §8.51(d) ("permitting indemnification of settlements and judgments in derivative proceedings would give rise to a circularity").

b. Trans Combo is not required, but is permitted, to reimburse litigation expenses in a derivative suit settlement. If the directors settle, they would not have been "wholly successful on the merits or otherwise," and there would be no mandatory indemnification. MBCA §8.52. Nonetheless, the directors may be entitled to indemnification of their litigation expenses—if they meet the statutory standards of conduct. MBCA §8.51(d)(1). Unlike a judgment of liability, a settlement leaves open the factual question of whether the directors acted in good faith and with a reasonable belief they were acting in the best interests of the corporation. See MBCA §8.51(c) (settlement is not determinative director did not meet standard of conduct). This means the corporation, to resolve derivative litigation, may end up paying both the shareholder-plaintiff's expenses (see §18.1.2) and the director-defendants' expenses.

c. Probably. Under MBCA §8.53(a), the corporation may advance a director's litigation expenses if

   (1) He affirms his good-faith belief that he is entitled to permissive indemnification under the statutory standard of conduct. That is, that when he rejected the merger he acted in good faith (not dishonestly or with a conflicting interest) and reasonably believing it was in the corporation's best interests.

   (2) He undertakes to repay all advances if it turns out he is not entitled to indemnification. Even though some of the directors may never be able to repay these advances, the MBCA permits the committee to accept their undertaking "without reference to financial ability to make repayment." MBCA §8.53(b).

   (3) A proper decision-maker determines it knows of nothing that would preclude indemnification. Advancing expenses, like indemnification for liability, is a form of self-dealing. The MBCA requires that any

discretionary decision to pay (or advance) expenses be made by directors (board or committee composed of at least two disinterested directors) or disinterested shareholders. MBCA §8.53(c) (unlike permissive indemnification, independent legal counsel cannot authorize advancement of expenses). If a quorum of the board consisting of nonparty directors cannot be obtained, the board may compose a committee of at least two nonparty directors—the case here. In approving the advance, the committee need not conduct a special investigation that the director would meet the standard of conduct. Official Comment to MBCA §8.53.

d. Yes. The advance of expenses is discretionary, and the corporation is under no statutory obligation. Unless the directors have nonstatutory rights in the corporation's articles or bylaws, or in an indemnification agreement, the statute limits mandatory indemnification to directors who are "wholly successful."

   Court-ordered indemnification, however, is available in some situations when the corporation has balked. See MBCA §8.54. The directors would have to show that it is "fair and reasonable" to advance the expenses. For example, the directors might show that the committee was acting out of spite and it was in the corporation's best interests for them to litigate the question of a director's duty to investigate merger proposals. The court can order the corporation to advance expenses even if the director was not entitled to this under the provisions of MBCA §8.53.

e. No. The MBCA requires that the directors be "wholly successful" to be entitled to payment of litigation expenses. MBCA §8.52. Even though the directors were successful in part of their defense, the MBCA seeks to prevent the result in *Merritt-Chapman & Scott Corp. v. Wolfson*, 321 A.2d 138 (Del. 1974), where an undeserving insider accepted criminal liability on one charge for the dismissal of others. Remember, though, that permissive indemnification may be available.

2. a. Yes. Typical D&O coverage extends to suits brought by or on behalf of the corporation. Typically, policies cover the directors for acts or omissions in their capacities as directors or by reason of their status as directors. They exclude coverage for claims of personal profit, deliberate fraud, criminal acts, unauthorized compensation, short-swing

trading profits, or failing to maintain insurance. That is, breaches of a director's duty of care are typically covered.

b. Yes. D&O policies typically cover defense costs. Some policies provide that the insurance company will conduct the defense and require that the insured directors turn over litigation to the insurance company.

c. No. D&O coverage, like nearly all other insurance, excludes coverage for willful, knowing, or fraudulent acts.

3. a. In this example, indemnification is not mandatory, but is permitted. In the merger the surviving corporation assumes all the liabilities of the Old Trans Combo, including any statutory indemnification obligations it would have had. See MBCA §11.07(a)(4).

There is no mandatory indemnification under the MBCA unless the directors are "wholly successful," which they would not be in the case of a settlement. Permissive indemnification, however, is possible in a class action. Here the settlement would be with Old Trans Combo shareholders, not the surviving corporation. New Trans Combo's payment to the directors will have the effect of the Harmon Group paying additional consideration for the merger. There is no problem of circularity.

b. Probably not. The MBCA, unlike Delaware's statute, does not permit extrastatutory indemnification unless it is consistent with the statute. The directors cannot enforce the indemnification bylaw against Old Trans Combo because it did not call for a determination that the directors had met their standard of conduct by a disinterested decision-maker. MBCA §8.51(a).

It might be argued, nonetheless, that because a new set of shareholders (the Harmon Group) will bear the costs of any payments by New Trans Combo, this is not a self-dealing transaction and it would not be inconsistent with the statutory scheme for an *outsider* to reimburse the directors if the directors met the standard of conduct. This argument, curiously, would put the Old Trans Combo directors in the position of having greater indemnification rights after the merger.

c. Yes. The MBCA requires that indemnification payments be disclosed to shareholders in the corporation's annual report. See MBCA §16.21(a). Most corporate statutes (including Delaware's) do not require this disclosure.

4. a. Perhaps. New Trans Combo acquires the indemnification obligations of Old Trans Combo in the merger. See answer 3a above. The MBCA, however, is not entirely clear about whether a company's mandatory indemnification obligations cover defense costs in an insider-trading case.

Mandatory indemnification applies to "any proceeding to which the director [or officer] was a party because he is or was a director [or officer]." MBCA §§8.52, 8.56(c) (officers have same mandatory indemnification rights as directors). Orkin could argue the SEC sued him for misusing inside information that he acquired "because" of his insider position. The statute's provisions on permissive indemnification, which allow indemnification in cases other than "conduct of official capacity," suggest that an insider's indemnification rights extend beyond corporate functions. See MBCA §8.51(a)(2); see also *University Savings Ass'n v. Burnap*, 786 S.W.2d 423 (Tex. App. 1990) (indemnification of director who successfully defended against tipping liability).

Some of the reasons for indemnification argue for finding the statute covers Orkin. Indemnification seeks to align the incentives of directors and officers with the risk-taking preferences of shareholders. So does stock ownership. Directors and officers may be reluctant to acquire shares if their service on the board may expose them to liability if they trade in the company's shares. To encourage share ownership by directors, an indemnification scheme allowing indemnification for trading in those shares makes sense.

b. Perhaps. Unless the D&O policy has a nonassignment clause, its coverage passes to New Trans Combo in the merger. Typically, D&O policies reimburse the company's indemnification of directors' liability or expenses pursuant to statute, contract, charter, or bylaw provision. D&O policies often exclude coverage for claims under §16(b) of the Securities Exchange Act of 1934, the provision for the disgorgement of short-swing profits. See §24.3. That is, insurance does not allow an insider to preserve his illegal trading profits. In this case, however, the director is not claiming a return of profits, and the exclusion would not seem to apply.

5. An indemnification contract might read as follows. Notice that the

agreement calls for the corporation to pay fines, judgments, and settlements without a specific determination by disinterested directors or shareholders, as contemplated by the MBCA. In addition, the agreement does not require that the director seek advancement of expenses by making the good-faith affirmation and undertaking to repay if necessary, also as required by the MBCA. It is possible that a court might read these requirements into the agreement because the agreement is explicitly governed by the MBCA, including its requirements that permissive indemnification and advancement of expenses comply with statutory procedures. See MBCA §8.58(a).

Dear Mr. Orkin:

This confirms the agreement between you and New Trans Combo (Corporation) concerning indemnification.

1. *Indemnification*. The Corporation indemnifies you in your capacity as officer and director (or either) of the Corporation to the fullest extent permitted by law.
2. *Notice*. You will notify the Corporation in writing of any proceeding (whether threatened, pending, or completed) with respect to which the Corporation might be required to provide indemnity. You will provide this written notice within ten (10) business days after first becoming aware that you may be, are, or were a party to such a proceeding. The notice will describe the proceeding and your status in the proceeding and will attach any documents filed in the proceeding. If you fail to provide timely notice, the Corporation will not be obligated to indemnify you with respect to that proceeding.
3. *Defense and advancement of funds*. Unless independent counsel determines that the Corporation is not obligated to provide indemnity, the Corporation will: (a) defend and settle at the Corporation's expense any claims against you in your capacity as officer or director of the Corporation; and (b) pay any fines, judgments, and amounts in settlement in connection with claims against you in your capacity as officer or director of the Corporation. You will cooperate fully in any defense or settlement undertaken by the Corporation. If it is ultimately determined that you are not entitled to indemnity with respect to payments or

expenses (including attorneys' fees) incurred by the Corporation, then you will reimburse the Corporation for these amounts.

4. *Insurance*. The Corporation will purchase and maintain director and officer liability insurance in the face amount of [typically $1 million] on your behalf under a standard such policy. If at any time after the first year of coverage you conclude that this coverage is inadequate, you will notify the Corporation. If the Corporation does not adjust coverage to your satisfaction, you may request that independent legal counsel (to be paid by the Corporation) review the adequacy of the coverage. Counsel's evaluation will be binding.
5. *Nonexclusivity and subrogation*. Your rights to indemnification and to advances under this agreement are not exclusive of any other rights to which you may be entitled. To the extent the Corporation has paid amounts under this agreement and you are also entitled to payment from any other person, the Corporation will be subrogated to any claim that you may have for such payment.
6. *Duration, governing law, severability*. This agreement will terminate on the later of (a) ten (10) years after you cease to be a director or officer of the Corporation, or (b) the final disposition of any pending proceeding as to which you have a right of indemnification under this agreement. This agreement is governed by [MBCA jurisdiction] law. The provisions of this agreement are severable. This agreement is binding on and will inure to the benefit of the Corporation's and your heirs, personal representatives, successors, and assignees.

Accepted:	New Trans Combo Corp.
By: ________________________	By: ________________________

CHAPTER 16

Corporate Opportunities and Unfair Competition

The duty of corporate managers to put corporate interests ahead of their own personal interests applies not only to dealings with the corporation but also to outside business dealings that affect the corporation. Financial harm to the corporation is just as real when a manager takes a profitable business opportunity from the corporation or sets up a competing business as when the manager enters into an unfair self-dealing transaction with the corporation.

But, just as self-dealing is not automatically void, corporate managers (directors and executives) are not flatly prohibited from taking outside business opportunities. Outside opportunities offer managers a means to diversify their own human capital, and a flat prohibition against outside business activities might well lead many managers to shun the corporate form. The *corporate opportunity doctrine*—a subset of the duty of loyalty—balances the corporation's expansion potential and the managers' entrepreneurial interests.

This chapter describes the corporate opportunity doctrine (§16.1), the definition of "corporate opportunity" (§16.2), the effect of corporate rejection or incapacity (§16.3), and competition with the corporation (§16.4).

§16.1 CORPORATE OPPORTUNITY DOCTRINE

§16.1.1 Prohibition against Usurping Corporate Opportunities

The corporate opportunity doctrine supplies corporate law a deceptively simple rule. A corporate manager (director or executive) cannot usurp corporate opportunities for his own benefit unless the corporation has rejected the opportunity. The plaintiff has the burden of proving the existence of a corporate opportunity.

The doctrine thus raises two issues:

- When does a business opportunity belong to the corporation and thus become a "corporate opportunity"? See §16.2 below.
- When can it be said the corporation has (or would have) rejected the opportunity, thus allowing the director to take it? See §16.3 below.

§16.1.2 Remedies for Usurping a Corporate Opportunity

A director who usurps a corporate opportunity without corporate rejection must share the fruits of the opportunity as though the corporation had originally taken it. Remedies include (1) liability for profits realized by the usurping manager, (2) liability for lost profits and damages suffered by the corporation, and (3) imposition of a constructive trust on the new business or the subject matter of the opportunity (such as land). *Farber v. Servan Land Co.*, 662 F.2d 371 (5th Cir. 1981) (requiring usurper to share profits with corporation after usurper resold business opportunity). Because an outside third party is on the other side of the opportunity, rescission is not available unless the third party had notice of the insider's wrongdoing.

The corporate opportunity doctrine thus gives the corporation an "option" to take for itself a business opportunity initially taken by a corporate manager. If the opportunity turns out well, the corporation can claim it for itself; if the opportunity flops, the corporation can choose not to pursue its rights.

§16.2 DEFINITION OF "CORPORATE OPPORTUNITY"

What is a corporate opportunity? The courts have articulated and applied a variety of definitions. Underlying these definitions are two conflicting premises:

- **Corporate expansion.** The corporation expects managers to devote themselves to expanding the corporation's business. This maximizes corporate profitability.
- **Manager entrepreneurialism.** Managers expect to have freedom to pursue outside business interests. This promotes entrepreneurial initiative.

It should not surprise you that the courts' attempts to accommodate these inconsistent premises have led to a variety of vague tests, which have evolved over time.

§16.2.1 Use of Diverted Corporate Assets

A fiduciary cannot develop a business opportunity using assets secretly diverted from the corporation. Requiring the fiduciary to share any profits derived from the misbegotten business simply enforces the prohibition against misappropriation.

This analysis is clearest when the assets are "hard" assets — such as when a director uses the corporation's cash, property, or employees to set up a business. In such cases the director is liable whether or not the corporation had an identifiable interest in taking the business opportunity itself and whether or not the business was related to that of the corporation. The real evil is not so much that the director took an opportunity for himself, but rather that he took something that belonged to the corporation to do it. *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939) (use of corporate funds).

Some courts, however, have refused to impose liability on directors who use corporate resources to develop an outside business if the opportunity was one in which the corporation did not have an interest or expectancy. See

Lincoln Stores v. Grant, 34 N.E.2d 704 (Mass. 1941) (refusing to impose constructive trust on competing store that managers set up while still employed by corporation because "company had no interest in or thought of acquiring it").

§16.2.2 Existing Corporate Interest—Expectancy Test

Many courts employ an *expectancy test* to measure the corporation's expansion potential. If the corporation has an existing expectancy in a business opportunity, the manager must seek corporate consent before taking the opportunity.

Corporate expectancies need not rise to the level of an ownership interest. For instance, an expectancy exists if the corporation is negotiating to acquire a new business or an executive learns of a business offer directed to the corporation. See *Thorpe v. CERBO, Inc.*, 676 A.2d 436 (Del. 1996) (finding usurpation when controlling shareholders responded to an outside offer to purchase a corporate subsidiary with a counteroffer to sell the shareholders' controlling interest in the parent). In this regard, the manager's secrecy in taking an opportunity supports a finding of corporate expectancy, on the assumption the manager's concealment suggests the corporation had an interest. Courts have also interpreted the expectancy test to cover opportunities of special or unique importance to the corporation for which there is a presumed expectancy. For example, a corporation's avowed interest in finding a new headquarters site or in acquiring patents necessary for its business fall within the shadow of the corporation's expansion expectancies. See *Northeast Harbor Golf Club, Inc. v. Harris*, 661 A.2d 1146 (Me. 1995) (finding corporate opportunity when country club president acquired for herself property adjacent to club's golf course, which real estate agent had offered to her in capacity as president on assumption club would be interested).

Frequently, expectancies can be shown when the manager misappropriates "soft" assets of the corporation (such as confidential information or goodwill) to develop a new business. On the other hand, if the opportunity came to the manager in his individual (not corporate) capacity, courts are more likely to conclude the opportunity was not corporate. See *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996). It is

important to note that the misappropriation of soft assets may also be subject to other prohibitions. For example, a director who uses customer lists or secret manufacturing processes of the corporation in developing his own business may be liable under state statutes prohibiting misappropriation of trade secrets.

§16.2.3 Corporation's Existing Business— Line-of-Business Test

Some courts apply a broad *line-of-business test* to measure the reach of the corporation's expansion potential. See *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939) (opportunity so closely associated with company's activities that it places insider in competition with company). Under the test, courts compare the new business with the corporation's existing operations. The corporation need not have an existing interest or a special need for the opportunity, or the manager need not learn of the opportunity in his corporate capacity. If the new project is functionally related to the corporation's existing or anticipated business, the manager must obtain corporate consent before exploiting it.

Under the line-of-business test a functional relation exists if there is a competitive or synergistic overlap that suggests that the corporation would have been interested in taking the opportunity itself. Consider *Miller v. Miller*, 222 N.W.2d 71 (Minn. 1974). Miller Waste, a closely held family corporation, was in the waste-reprocessing business. Rudolph Miller, one of Miller Waste's managers, developed a patented lubricator for diesel locomotives and set up his own company for their manufacture. Rudolph's company was supplied with waste products produced by Miller Waste's reprocessing business and competed with Miller Waste in the locomotive lubricator market. The court held that a fact finder could have found that Rudolph's business was in Miller Waste's line of business.

§16.2.4 Eclectic Approaches

ALI Principles

The ALI Principles of Corporate Governance lay out a comprehensive approach to corporate opportunities, one which goes beyond the case law. The ALI Principles begin with a definition that combines the narrower

expectancy test and a broader line-of-business test. Under the ALI Principles *corporate executives* are subject to line-of-business and expectancy restrictions, while *outside directors* (who have no employment relationship with the corporation) are subject only to expectancy restrictions. See ALI Principles §5.05(b). The difference between corporate insiders and outsiders reflects a view that the corporation is able to demand greater loyalty of corporate insiders than of outsiders.

Fairness Test

Some courts go beyond the expectancy and line-of-business tests, and add (for good measure) an additional malleable fairness test. *Lewis v. Fuqua,* 502 A.2d 962 (Del. Ch. 1985). The fairness test in this context, unlike that for self-dealing, which focuses on the transaction's fairness to the corporation, focuses on the fairness of holding the manager accountable for his outside activities.

Again *Miller v. Miller*, 222 N.W.2d 71 (Minn. 1974), illustrates. Rudolph and Benjamin Miller had exploited a variety of opportunities for themselves that were closely related to Miller Waste's waste-reprocessing business. Rudolph had started a business that manufactured patented lubricators for diesel locomotives using waste filter elements; and together they had set up a packaging business and a plastics business that used waste cotton cuttings. The trial court found that none of the new businesses were within Miller Waste's line of business—a finding that seems factually questionable. On appeal the court, without upsetting the trial court's findings, held in addition that Rudolph's and Benjamin's taking of the new businesses was not unfair to Miller Waste. The new businesses had benefitted Miller Waste by supplying it with a captive market for selling its products; no corporate assets were diverted; there was no secrecy; and Rudolph and Benjamin had continued to work long hours at the waste mill. In the case, the fairness test recognized the managers' entrepreneurial interests and limited the breadth of the line-of-business test.

Service on Multiple Boards

To which corporation does a director owe allegiance when he serves on multiple boards? Courts have shown sensitivity to the dilemma of a director with conflicting duties. For example, consider the situation of Richard F. Broz, an outside director of a cell phone company (Cellular Information

Systems) and owner of his own cell phone company (RFB Cellular). CIS operated in the Midwest and RFB in the Upper Peninsula of Michigan. When a third company decided to sell its cellular license for the eastern tip of the Upper Peninsula, its broker contacted Broz but not CIS. Broz dutifully asked CIs's chief executive whether CIS would be interested in buying the license from the third party, and the CEO declined because CIS was strapped for money. So Broz went ahead on his own.

Soon afterward, CIs's financial fortunes turned when a large firm (PriCellular) agreed to buy the struggling company and inject it with new money. Then, before its purchase of CIS, PriCellular made a bid for the Mackinaw license, but Broz upped his bid and won. Had Broz violated his duties to CIS? Ultimately, the Delaware courts decided he had not. See *Broz v. Cellular Information Systems, Inc.,* 673 A.2d 148 (Del. 1996) (reversing a decision by Chancellor Allen). The court held that Broz had not taken a corporate opportunity of CIS. First, the court questioned whether CIS had a sufficient expectancy. The third-party license holder had not considered CIS a viable candidate for the license. At the time Broz bought the license CIS was in financial straits and was actually divesting its cellular license holdings. Although PriCellular had promised financial help, it had not yet acquired CIS. Second, the court noted Broz's duties to his own cell phone company, of which CIS was "wholly aware." That is, CIS knew that Broz had another master, which could well come first.

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§16.3 CORPORATE REJECTION AND INCAPACITY

Even if a court determines that a business opportunity is a corporate opportunity under the applicable test, the corporation's interest is negated if the corporation either consents to the taking by a corporate manager or was unable to take the opportunity itself. By accepting that managers may engage in outside ventures under some circumstances, the corporate opportunity doctrine recognizes the entrepreneurial interests of managers.

Some courts have folded the question of corporate consent and incapacity into the question of whether the opportunity was a corporate opportunity, for example, placing the burden to show capacity on the corporation. Other cases separate the issues, treating them as defenses to be proved by the enterprising

manager. The ALI Principles take the view that the corporation's capacity to take an opportunity is a matter to be decided by the corporation, not a court after the fact.

§16.3.1 Corporate Rejection

The corporation can voluntarily relinquish its interests in a corporate opportunity (for many reasons, such as financing difficulties or risk concerns) by generally renouncing any interest in categories of business opportunities or by rejecting a specific deal. Delaware's corporate statute permits a corporation to "renounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in … specified business opportunities or specified classes or categories of business opportunities" presented to the corporation. Del. GCL §122(17); see also MBCA §8.70 (permitting qualified directors or shareholders to disclaim corporation's interest in opportunity).

The corporation's rejection of a specific opportunity, however, may itself be a self-dealing transaction because of the possible conflict between the manager's and the corporation's interests. Some courts subject corporate rejection, like the approval of a self-dealing transaction, to fairness review and require rejection by informed, disinterested directors or shareholders. See *Telxon Corp. v. Meyerson*, 802 A.2d 257 (Del. 2002) (stating that board's informed, considered refusal of corporate opportunity creates safe harbor for interested director). Other courts have held that informal acquiescence to the taking (particularly in closely held corporations) constitutes rejection. Cf. *Farber v. Servan Land Co.*, 662 F.2d 371 (5th Cir. 1981) (finding shareholder inaction did not constitute acquiescence because shareholders relied on usurping insider to investigate business opportunities).

Sometimes courts have folded together the questions of corporate consent and the existence of a corporate opportunity. For example, in *Burg v. Horn,* 380 F.2d 897 (2d Cir. 1967), the part-time managers of a closely held real estate firm acquired other properties with the tacit consent of their co-shareholder. The co-shareholder knew from the start that the managers held and managed other similar properties. Further, the properties acquired by the managers (though in the same line of business as that of the corporation) had not been offered to or sought by the corporation. The co-shareholder's informal acquiescence to the managers' outside entrepreneurialism led the

court to conclude they had not usurped a corporate opportunity.

§16.3.2 Corporate Incapacity

Many courts allow managers charged with usurping a corporate opportunity to defend that the corporation could not have taken the opportunity because it was financially incapable or otherwise unable to do so. See *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996) (refusing to find corporate financial capacity when director acquired cell phone license at time cash-strapped corporation was being acquired by another, better-financed company interested in the license). Under this approach, it is not determinative that the manager failed to inform the board. The question of incapacity is left to the court.

If the opportunity was never presented to the board or the shareholders, courts must speculate whether the corporation could have taken the opportunity. This leads to slippery arguments. Even if a manager shows the corporation lacked the funds to take the opportunity itself, it can always be argued that the corporation could have raised the funds by borrowing money or by issuing new stock. After all, the manager had sufficient access to capital to take the opportunity himself, and allowing a manager to later claim corporate incapacity may tempt the manager to not exercise his best efforts to bring the opportunity to the corporation.

Because of the vagaries of these after-the-fact inquiries, some courts have rejected the incapacity defense on the theory that the determination whether the corporation has the financial, legal, and institutional capacity to take the opportunity should be made by informed corporate decision-makers, not the corporate fiduciary. See *Demoulas v. Demoulas Super Markets, Inc.*, 677 N.E.2d 159 (Mass. 1997) (whether out-of-state supermarket chain could legally acquire stores under New Hampshire liquor laws should be decided by informed board, not fiduciary). Delaware, however, has taken the view that formal presentation of an opportunity to disinterested corporate decision-makers is not required. See *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996). Instead, the manager can decide the opportunity is one the corporation is incapable or unwilling to take—though at his risk.

§16.3.3 ALI Principles: Mandatory Disclosure and

Rejection

The ALI Principles assume that the corporation's capacity to take an opportunity is for the corporation to decide, not the manager and later a judge in litigation. The ALI Principles thus take a disclosure-oriented approach that mandates informed corporate rejection before a manager can take a "corporate opportunity." Under this approach, (1) the manager must have offered the opportunity to the corporation and disclosed his conflicting interest, and (2) the board or shareholders must have rejected it. ALI §5.05(a). The manager's failure to offer and disclose the opportunity to the corporation thus creates automatic liability.

If disinterested directors have rejected the opportunity, the board's action is subject to review under the business judgment rule. If rejected by disinterested shareholders, review is under a waste standard. And if the rejection is not disinterested, or the challenger shows waste or a lack of business judgment, the defendant must then prove that the taking was fair to the corporation. ALI §5.05(a), (c).

In *Klinicki v. Lundgren*, 695 P.2d 906 (Or. 1985), the court applied this offer-rejection approach to the president of a closely held air transportation company who secretly took for himself a contract for a new air charter business. The court refused to consider the president's contention that the company lacked the financial ability to undertake the contract because the opportunity had never been presented to the other participant in the corporation. Under the ALI Principles, the offer-rejection "safe harbor" is exclusive.

16.4 COMPETITION WITH THE CORPORATION

Competition with the corporation, although often the usurpation of a corporate opportunity, is subject to special treatment. In general, during their relationship with the corporation, managers may not compete with the corporation unless there is no foreseeable harm caused by the competition or disinterested directors (or shareholders) have authorized it. The prohibition applies whether the competing business is set up during the manager's tenure

or was preexisting.

This noncompete duty goes beyond the duties of the corporate opportunity doctrine. A manager with an interest in a competing business that predates his joining the corporation usurps no corporate opportunity, but may be liable in damages for continuing to compete. Further, if the manager does not divert assets in setting up a competing business and if the corporation has no existing interest or need to expand, neither the misappropriation nor the expectancy theory prevents the manager from setting up the competing business.

A manager who violates the noncompete duty may be liable in damages for any competitive losses suffered by the corporation, but the manager need not share the competing business unless setting up the business usurped a corporate opportunity. See *Lincoln Stores v. Grant*, 34 N.E.2d 704 (Mass. 1941) (imposing damages, but no constructive trust, on managers who set up competing store while still employed by corporation).

Other theories of liability may also apply to a manager who competes with the corporation: (1) breach of contractual covenant not to compete, (2) misappropriation of trade secrets (such as customer lists or confidential formulas), or (3) tortious interference with contractual relationships if the manager induces the corporation's customers or employees to follow him.

Examples

1. Atlantis Bottling, Inc., is the authorized bottler of Gusto Cola on the Atlantic seaboard. The corporation is owned and operated by the Garret family. A few years ago, Ruth Garret (Atlantis's founder and largest shareholder) brought her unemployed brother Percy into the business. He is now chief executive officer, and Percy often says, "I owe everything to Ruth." Recently, Percy set up his own chain of dessert shops, which has become highly profitable.
   a. Ruth is distressed and thinks Percy should be forced to share the chain's profits with Atlantis. Percy set up the dessert shops with loans that Atlantis guaranteed under Percy's unauthorized signature. Must Percy share his profits? Under what theory?
   b. As things turn out, Ruth got the facts wrong. Percy set up the dessert shops on his own time and with his own money without using the company's credit. Atlantis had no plans to diversify into the dessert business. Can Percy be forced to share his profits?

c. Ruth points out that from the beginning the Garret family understood "everyone would pitch in and everyone would be taken care of." Does this understanding affect whether Percy must share his profits?

2. Atlantis managers have been considering installing new lighting at the company's dingy bottling plant. Sally Garret (Ruth's niece and supervisor of the plant) has drawn up a new lighting design, which she plans to submit to the board.

   a. Before Sally submits her plan, Percy receives a letter from DustriLite that it is going out of business and is liquidating its industrial lighting inventory. Without telling anyone, Percy uses his own money to buy a boxcar of DustriLite lighting fixtures—cheap! When the board approves Sally's plan, Percy resells the fixtures to Atlantis at the prevailing market price. Must Percy share his profits? Under what theory?

   b. Would it make any difference if Percy had originally disclosed the DustriLite offer to Atlantis's board and the board had at first turned down the offer?

   c. What if DustriLite had sold its inventory to Percy at a discount as a way to express its thanks for his steering Atlantis business to DustriLite. Must Percy share a personal gratuity?

3. Atlantis's sales have fallen recently and some of the company's bank lenders have expressed concern to Percy about the company's ability to repay its outstanding loans.

   a. Percy, swimming in cash because of his successful dessert shops, wants to get the banks off Atlantis's back. He believes that Atlantis's credit is basically sound, and he buys Atlantis's loans from the banks at a deep discount. Can he be forced to share this discount with Atlantis?

   b. Percy believes the banks would not have been willing, on principle, to allow Atlantis to renegotiate its debt. Does this affect Percy's duties?

   c. Percy claims that everyone else at Atlantis knew about the banks' nervousness and did nothing. Does this affect Percy's duties?

4. Ofelia, a nationally known "beverage consultant" and an outside director on Atlantis's board, reads in the newspaper that Tanfa Beverages is going out of business. Tanfa is a bottler of fruit-flavored sodas in California,

and Ofelia calls Tanfa's president, who confirms the company is for sale.

a. Atlantis's board has never discussed expanding outside the Atlantic region, its traditional geographic niche. Ofelia figures Atlantis would not be interested in Tanfa. She wants to buy Tanfa for herself, but without disclosing her plans to Atlantis. Can she?

b. Atlantis's board has lately had extensive discussions about the company's "cash flow difficulties." Ofelia figures Atlantis lacks the funds to buy Tanfa. Does this affect her duties?

c. Ofelia buys Tanfa and convinces Jack Garret (Atlantis's promotional director) to leave Atlantis and work for Tanfa. Do you see any problems?

Explanations

1. a. Yes, under a misappropriation theory. Percy's unauthorized use of Atlantis's credit is as much a diversion of assets as if he had misappropriated money. His wrongful use of corporate resources imposes on him a duty not to take the opportunity whether or not Atlantis had any interest in opening dessert shops itself or whether the shops were related to Atlantis's existing soft drink business.

   Some courts, however, would limit Atlantis's recovery to the damages resulting from Percy's unauthorized use of the company's credit. See *Lincoln Stores v. Grant*, 34 N.E.2d 704 (Mass. 1941) (§16.2.1). If so, Percy would be liable for the value of Atlantis's guarantee.

   b. Unlikely. Percy's dessert business is not a "corporate opportunity" under any of the definitions applied by the courts.

   - Percy did not misappropriate corporate assets in setting up his business.
   - There is no indication Atlantis had any plans or need to enter the dessert business. Percy started the business on his own time and presumably with information he derived from outside Atlantis.
   - The business opportunity is not within Atlantis's "line of business" because the dessert shops are not functionally related to the bottling business. There is no overlap in raw materials, production, and marketing. Even if Atlantis's charter permitted it and Atlantis had the financial means to expand into dessert shops, the line-of-business

test does not treat every profitable business as within a corporation's expansion potential. In recognition of managers' entrepreneurial interests, the opportunity must be closely related to the company's existing or contemplated business.

- Percy's new business does not compete with Atlantis for customers, suppliers, employees, or assets.

c. Perhaps. Ruth could argue that Percy had a duty to share the opportunity because of the special expectations in this close corporation. The argument parallels the "reasonable expectations" argument that courts have increasingly come to accept in close corporation freezeout cases (see §27.2.1). If the participants in this family business had a "share and share alike" understanding—that a business opportunity available to any of them should be made available to the family corporation—a court might apply broader notions of corporate expectancy and line of business. Moreover, courts have frequently suggested that corporations can expect more of full-time managers (such as CEO Percy) than part-time managers or outside directors.

That is, the corporate opportunity doctrine provides a default rule that the parties have some leeway to contract around. The ALI Principles, for example, permit corporate participants to establish a "standard of the corporation" that permits the taking of specified corporate opportunities without further disinterested approval. ALI Principles §5.09. By the same token the corporation, just as it sometimes obtains noncompete promises, could expand the definition of what constitutes a corporate opportunity. Even if a court were to give significance to the family's "share and share alike" understanding, it should also consider Percy's entrepreneurial desire to diversify his human capital by branching into new businesses.

2. a. Yes, under an expectancy theory. The DustriLite opportunity was an existing expectancy of Atlantis because of Sally's plans for new lighting at the plant. It seems clear that Percy knew about her plans, given his secrecy and prescience to buy the right fixtures. If, for some reason, Percy did not know about the plans or that Atlantis might be interested in the fixtures, his *innocent* taking of a business opportunity would not be the breach of his fiduciary duties.

It makes no difference that the board had not yet approved Sally's plans or that Atlantis's interest was not based on preexisting rights (such as a DustriLite contract with Atlantis). Even though Atlantis could not legally preclude Percy or anyone else from purchasing the fixtures, Atlantis's plans were far enough along to impose on Percy a duty not to take the opportunity without allowing the corporation to consider it.

In these circumstances, a line-of-business theory would not work because buying lighting fixtures is not part of Atlantis's bottling business. The line-of-business test does not compel Percy to get permission to become a lighting-fixture marketer.

You might have noticed also that Atlantis could have sought damages from Percy on a self-dealing theory because he sold the fixtures to the corporation (see §13.1). Although the transaction's price might have been the fair market price, a court could characterize it as procedurally unfair—particularly if Percy failed to disclose how much he stood to profit when he made the sale. In such a case, the self-dealing remedy of rescission would be inadequate; courts have held that damages under a corporate opportunity theory are appropriate.

b. Yes, if the board had also known of Sally's lighting plans. Under most judicial approaches, the rejection of the opportunity by informed, independent, and disinterested directors of the Atlantis board relinquishes the corporation's claim to it, freeing Percy to take it for himself. Not only would Percy have to disclose the terms of the DustriLite offer, but also Sally's lighting plans and his intentions if the board turned down the offer. For the directors to be considered disinterested, they cannot have a financial interest in the lighting fixtures; and for them to be considered independent, Percy cannot dominate their decision-making (§13.3.3).

c. Probably, because the gratuity was for past business with Atlantis, not with Percy. A similar question recently arose in the context of the allocation of IPO shares to corporate directors by an investment bank seeking to foster a relationship with the directors' company. See *In re eBAY, Inc. Shareholders Litigation*, 2004 WL 253521 (Del. Ch. 2004). When the directors turned around and sold the IPO shares for millions of dollars in profits, shareholders brought a derivative suit. Without

deciding whether the allocations were a corporate opportunity, the court decided they constituted consideration for continued business with the company, and thus the directors had (at the least) breached their fiduciary duties of loyalty by taking something that belonged to the company.

3. a. Perhaps. Percy's purchase of the debt would mean that Atlantis would owe him 100 percent principal and interest under its loans even though Percy had paid less than 100 percent for these rights. Atlantis could use an expectancy theory to characterize Percy's purchase of its discounted debt as a corporate opportunity and compel Percy to share the profits from his refinancing of the debt. Even if Atlantis had not expressed an interest in restructuring its debt, Atlantis could argue it (like any business) has an ongoing interest in repurchasing its own securities or obligations at a discount because of their "unique value" to the corporation.

On the other hand, Percy could argue that he was simply assuming Atlantis's credit risk from the bank and purchased the debt at market value. There is nothing to indicate Atlantis could have refinanced its debt with a lender other than Percy. It would be unfair to compel Percy to share any gains because his purchase of Atlantis's debt meant only he would bear any losses if Atlantis did not repay on schedule. His argument would be buttressed if Percy, not the banks, initiated the idea of refinancing or repurchase of the debt.

b. Perhaps. If the banks would have been unwilling to sell back their loans to Atlantis at a discount, Atlantis lacked the corporate capacity to take the opportunity itself. Some courts treat corporate capacity as an element of corporate opportunity. See *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996). If Percy could show that the banks would not have dealt with Atlantis, his loan purchase would not be treated as a corporate opportunity. This forces a court to speculate on what might have happened, placing the corporation at a disadvantage to rebut the banks' after-the-fact statements about not giving discounts to borrowers.

Because of this, a modern judicial trend (reflected in the ALI Principles, but rejected in Delaware) is to compel the manager to seek corporate rejection. If the banks are truly unwilling to deal with

Atlantis, the company's disinterested participants presumably would have rejected even attempting the impossible opportunity. Under this approach, Percy would walk a dangerous line by not seeking formal corporate rejection.

c. Perhaps. Percy might be able to characterize the Atlantis inaction as an implied rejection of the opportunity to refinance its debt. Some courts, particularly in cases involving closely held corporations, have treated acquiescence as rejection of an opportunity.

Nonetheless, the approach of other courts, and of the ALI Principles, is to avoid speculation about corporate capacity. Under the ALI Principles, for example, the opportunity must be offered to the corporation and rejected by the board or shareholders. ALI Principles §5.05(a)(2). To meet the standards of the business judgment rule, the ALI Principles imply that rejection by the board must be by formal action; shareholder action must be taken at a meeting. This approach may not make much sense in a close corporation, such as Atlantis, where the corporate participants may act casually without corporate formalities.

4. a. Perhaps not. The Tanfa opportunity may be an opportunity within Atlantis's line-of-business expansion potential, but not necessarily one that outside director Ofelia must disclose or share. Although Atlantis has no present plans to expand into the West Coast market, the line-of-business test does not depend on actual expectancies. Tanfa is in the same business as Atlantis, though the two bottlers do not sell in the same markets. Atlantis's acquisition of Tanfa would create new opportunities for expanding Atlantis's existing business. It would provide new products for Atlantis's current markets and open a new market for its existing products.

Some courts, however, would consider Ofelia's position as a nonexecutive outside director. Her entrepreneurial interests are presumably greater because she is not an employee of Atlantis, and her outside status diminishes the corporation's expectations in her exclusive loyalty. Under the ALI Principles, for example, a line-of-business opportunity is not considered a "corporate opportunity" when an outside director learns of it in a noncorporate capacity. See ALI Principles §5.05(b).

b. Perhaps. If the opportunity were considered a corporate opportunity for Atlantis, Ofelia's incapacity defense depends on whether a court would require the board to make the call (after disclosure by Ofelia) or whether the court would decide the issue on its own. Some courts, particularly in Delaware, allow the defense even though the opportunity was never presented to the corporation. The burden of proving financial incapacity is difficult. Ofelia will have to show Atlantis could not have raised the money through new debt or equity financing. The argument that financing was unavailable will ring hollow because Ofelia seems able herself to afford the acquisition.

   Some courts, and the ALI Principles, have rejected the incapacity defense. Under their approach, corporate incapacity must be decided by fully informed, disinterested directors or shareholders. If the Tanfa opportunity were a corporate opportunity for Atlantis, the board would have to reject it. Under this approach, however, Ofelia need not offer to lend money to the corporation so it can make the acquisition.

c. Yes, on three possible grounds.

   First, whether or not the acquisition of Tanfa is a corporate opportunity, Jack's continued employment with Atlantis might itself be seen as an opportunity. Atlantis could argue it has an expectancy that Jack will stay with Atlantis (particularly if he is under contract or is subject to a covenant not to compete) and that his services have special value to Atlantis. By hiring him away, Ofelia has usurped a corporate opportunity.

   Second, Tanfa is now competing with Atlantis, and Ofelia (as a fiduciary of Atlantis) is under a broad duty not to harm Atlantis competitively. (Notice that this may conflict with her duties to Tanfa and force her to cut her ties to one or the other. Ofelia can compete with Atlantis after she resigns from her board position.)

   Third, if Jack is under contract and particularly if he is subject to a noncompete covenant, Ofelia may have tortiously interfered with Atlantis's contractual relationship by wooing Jack away.

CHAPTER 17

Duties of Controlling Shareholders (Corporate Groups)

Corporate fiduciary duties apply to those who control the corporate governance mechanisms. Not only are directors and officers accountable, but also any shareholder with voting control—a *controlling shareholder*. With the power to select the board and approve fundamental changes, a controlling shareholder can act to the detriment of minority shareholders. For this reason, courts impose fiduciary duties on controlling shareholders that generally parallel those of directors.

This chapter describes controlling shareholders (§17.1), how courts scrutinize transactions between controlling shareholders and the corporation—the duties in corporate groups (§17.2) and the special scrutiny given to squeeze-out transactions (§17.3). Our focus is on public corporations and parent-subsidiary dealings. The special duties of controlling shareholders in close corporations are discussed in Chapter 27.

§17.1 Who are Controlling Shareholders?

A controlling shareholder, whether an individual or a parent corporation, has sufficient voting shares to determine the outcome of a shareholder vote. Directors are usually elected by plurality or majority vote, and any shareholder who can assemble a voting majority wields effective control of the board. In close corporations, effective control may require a shareholding

of more than 50 percent—a majority shareholder. In a public corporation with widely dispersed shareholders, it may be enough to own as little as 20 percent and have the support of the incumbent board—a dominating shareholder. ALI §1.10(b) (presumption of control with 25 percent shareholding); but see *Williamson v. Cox Communications, Inc.,* 32 Del. J. Corp. L. 307 (Del. Ch. 2006) (concluding that shareholder with less than 50 percent interest not controlling, unless shareholder actually exercises control over subsidiary, beyond installing directors or exercising veto).

Why would shareholders ever invest in a business controlled by another shareholder? There are a number of reasons. A controlling shareholder has greater incentives and means to monitor management, a benefit shared by all shareholders. The controlling shareholder may also have other businesses, creating opportunities in the corporate group for economies of scale and captive markets.

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§17.2 PARENT-SUBSIDIARY DEALINGS

In a public corporation setting, dealings between a controlling shareholder (the parent) and the corporation (the subsidiary) raise many of the same conflict-of-interest concerns as do dealings between a director and the corporation. For a parent and its subsidiary, multiple sources of conflict exist. Executives of the parent often serve on the board of the subsidiary; parent company executives often dictate (directly and indirectly) the subsidiary's operational policies and decisions; and the parent, by definition, has a controlling shareholding position.

§17.2.1 Dealings with Wholly-Owned Subsidiaries

When a subsidiary is wholly owned and there are no minority shareholders, the parent has virtually unfettered discretion to do with the subsidiary corporation as it pleases. Duties exist only to corporate creditors and, to a limited extent, future minority shareholders. For example, promoters cannot enter into unfair self-dealing transactions to the detriment of future creditors or shareholders (see §29.3), and controlling shareholders are liable for siphoning corporate funds at the expense of creditors (see §32.1). But if these interests are not implicated, there is no conflict when a parent corporation

deals with its wholly-owned subsidiary.

§17.2.2 Dealings with Partially-Owned Subsidiaries

Dealings between a parent and its partially-owned subsidiary create risks of control abuse. Consider some examples:

- **Dividend policy.** The subsidiary declares dividends to a cash-strapped parent at the expense of internal expansion. Or the subsidiary adopts a no-dividend policy to force minority shareholders to sell to the parent.
- **Share transactions.** The subsidiary issues shares to the parent at less than fair value, thus diluting the minority's interests. The subsidiary purchases shares from the parent at more than fair value.
- **Parent-subsidiary transactions.** The subsidiary enters into contracts (with the parent or related affiliates) on terms unfavorable to the subsidiary, effectively withdrawing assets of the subsidiary at the expense of the minority.
- **Usurpation of opportunities.** The parent (or other affiliate) takes business opportunities away from the subsidiary.

When must the parent answer to the minority? Corporate statutes provide little guidance. Although conflict-of-interest statutes by their terms cover transactions when a director has a relationship to another corporation—the usual situation in parent-subsidiary dealings—the statutes either fail to provide conclusive standards of review for parent-subsidiary dealings or explicitly exclude such transactions from their reach. See Del. GCL §144 (declaring the nonvoidability of corporate transactions with director or entity in which director has an interest); Note on Parent Companies and Subsidiaries, MBCA §8.60(1) (stating that safe harbor provisions for director's conflicting interest transactions have "no relevance" to parent-subsidiary transactions, which in practice are dealt with "under the rubric of the duties of a majority shareholder").

§17.2.3 Judicial Review of Parent-Subsidiary

Dealings

Courts have wavered on the degree of scrutiny applicable to parent-subsidiary dealings. Although using much of the terminology and analysis applicable to director dealings, courts have recognized the prerogatives that come from owning a controlling interest. See *Thorpe v. CERBO, Inc.,* 676 A.2d 436 (Del. 1996) (refusing to impose lost-profits liability on controlling shareholders who failed to make information on potential buyout of subsidiary available to subsidiary's board, since controlling shareholders could have used voting power to block the buyout).

Ordinary Business Dealings

Most courts, including in Delaware, view with sympathy the argument that a parent corporation should be able to exercise its control. Parent-subsidiary dealings in the ordinary course of business are subject to fairness review only if the minority shows the parent has preferred itself at the minority's expense. If so, the courts presume the parent dominates the subsidiary's board and places the burden on the parent to prove the transaction was "entirely fair" to the subsidiary. See ALI §5.10 (burden on parent unless approved by disinterested directors). But if there is no preference, the transaction is subject to business judgment review, and the minority must prove that the dealings lacked any business purpose or that their approval was grossly uninformed.

Sinclair Oil v. Levien

The dichotomous judicial treatment of parent-subsidiary dealings—scrutiny of preferential dealings and deference to nonpreferential dealings—is illustrated in *Sinclair Oil Co. v. Levien*, 280 A.2d 717 (Del. 1971). Minority shareholders of Sinven, a partially-owned (97 percent) Venezuelan subsidiary of Sinclair Oil, challenged three sets of parent-subsidiary dealings:

- **Sub's high-dividend policy.** The minority alleged Sinclair had imposed on Sinven a dividend policy that depleted the subsidiary. The court held that the policy did not prefer Sinclair because Sinven's minority shareholders received their proportionate share of all dividends. In the absence of preferential treatment, the shareholders had the burden to show that the policy was not protected by the business judgment rule,

which they failed to do.

- **Parent's allocation of projects to other affiliates.** The minority claimed Sinclair allocated industrial projects to its wholly-owned subsidiaries, to the detriment of partially-owned Sinven. The court held that the projects were not corporate opportunities of the subsidiary, and the parent was under no obligation to share them with Sinven.
- **Sub's failure to enforce contracts with other affiliates.** The minority claimed that Sinven's nonenforcement of contracts for the sale of oil products to other Sinclair affiliates preferred the affiliates to Sinven's detriment. The court treated the nonenforcement as self-dealing and held that Sinclair had failed to show that nonenforcement was fair to Sinven.

The key in each instance was whether the minority shareholders could show a clear parental preference detrimental to the subsidiary. The *Levien* test assumes the propriety of parent-subsidiary dealings, a departure from the traditional rule that fiduciaries have the burden to show the fairness of their self-interested dealings. See §13.2.3. The burden is on the minority shareholders to show the dealings were *not* those that might be expected in an arm's-length relationship, rather than on the parent to show that they were.

Exclusion of Minority

Some courts hold controlling shareholders to a higher standard when they use control in stock transactions to benefit themselves to the exclusion of minority shareholders. In the leading case, the court imposed on the controlling shareholder the burden to prove that a stock transaction that excluded minority shareholders was justified by a "compelling business purpose." *Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969). United Savings & Loan was controlled by Howard Ahmanson, who had made the S&L a great success. But the S&L's shareholders were unable to capitalize on the success because of a thin market for their shares. Although publicly held, the S&L had less than 7,000 outstanding shares, which traded at $2,400 per share. As a result, few investors were interested in buying even though S&Ls were then darlings of the stock markets.

To remedy this, Ahmanson set up a holding company (United Financial) that exchanged its stock for the S&L shares he and his friends owned—all told, 85 percent of the S&L shares outstanding. United Financial's shares became widely traded, creating a lucrative market for Ahmanson's majority

interest in the S&L. The plaintiff, a minority shareholder who was not allowed to participate in the exchange, argued that Ahmanson should have created a market for all the S&L shareholders by splitting the S&L stock on a 250-for-1 basis. Ahmanson argued that he and the other favored shareholders had an unfettered right to do with their shares as they pleased, and that the exchange had not affected the plaintiff's legal interest in the S&L, which remained unchanged.

Writing for the court, Justice Traynor rejected Ahmanson's argument and held that controlling shareholders have fiduciary duties to minority shareholders. Even accepting (as the plaintiff conceded) that Ahmanson had caused no harm to the corporation, Traynor said that controlling shareholders cannot use their control to benefit themselves to the detriment of the minority. Ahmanson violated a duty to the minority by creating a market from which the minority shareholders were excluded without a compelling business purpose. The court required that the minority shareholders have an opportunity to exchange their S&L shares for a proportionate number of holding company shares.

Other courts have used this analysis to invalidate stock redemptions and conversions that prefer controlling shareholders. For example, in *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947), a corporation had two classes of common shares, class A and class B. The class B shares held voting control. The class A shares, which were entitled to twice as much in liquidation as class B shares, could be redeemed by the corporation at any time for $60. The controlling shareholder had the corporation redeem all of the minority's class A shares and then liquidate the corporation's assets, which had recently tripled in value. The result was that the controlling shareholder received the lion's share of the company's liquidation value. The court stated there was "no reason" for the class A redemption except for the controlling class B shareholder to profit. In a subsequent opinion, the court upheld a recovery by the class A shareholders based on the liquidation value they would have received had they exercised their rights to convert their class B shares into class A shares. See *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956).

Approval by Disinterested Shareholders

Just as shareholder ratification insulates directorial self-dealing from review, approval by a majority of informed, disinterested shareholders of the

controlled subsidiary insulates a parent-subsidiary transaction. If the parent discloses the conflict and the terms of the transaction, the transaction is subject to review only under a waste standard. That is, a challenger must show there was no rational business justification for the transaction. ALI §5.10(a)(2).

Remedies

Remedies for improper parent-subsidiary dealings are the same as those for self-dealing by directors (see §13.5). Rescission is the general remedy unless it is inadequate—such as when a parent usurps the subsidiary's corporate opportunities—or rescission is no longer possible. When a controlling shareholder transacts in the corporation's stock to the detriment of the minority, courts permit minority shareholders to sue directly and seek either equal treatment in the transaction or a recovery based on what the minority would have received absent the breach.

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§17.3 SQUEEZE-OUT TRANSACTIONS—ELIMINATING MINORITY INTERESTS

Controlling shareholders often seek to buy out minority interests—particularly in corporate takeovers. Modern courts, though permitting controlling shareholders to structure transactions that eliminate minority interests, place significant restrictions on such transactions whose structure and terms are dictated by the controlling shareholder.

Note on Shift of Litigation Away from Delaware

Corporate takeovers—whether negotiated or hostile—usually end with a court challenge to the terms of the "squeeze-out" merger in which the acquiring company consolidates its control. Such challenges are typically brought by shareholders (and their law firms) looking to negotiate improved terms in the squeeze-out merger—and to collect attorneys' fees for their efforts. In the past several years, Delaware judges have become reluctant to readily grant requests for attorneys' fees to the lawyers bringing (or intervening in) such cases. As a result,

many such cases have lately been filed in jurisdictions other than Delaware. Although Delaware corporate law still applies, the plaintiffs' lawyers have assumed that they will be treated more favorably by non-Delaware judges, whose experience with corporate litigation will typically be less extensive. See Armour, Black, & Cheffins, *Is Delaware Losing Its Cases?* SSRN Paper 1578404 (2010).

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§17.3.1 Squeeze-Out Mechanics

Consider the ways a controlling shareholder can force out minority shareholders and acquire 100 percent control:

- **Squeeze-out merger.** The parent and subsidiary agree to a merger under which the subsidiary's minority shareholders receive cash (a cash-out merger) or other consideration for their shares. The parent retains the subsidiary's shares and becomes its sole shareholder or the subsidiary merges into the parent as a new division. See §32.2.6 (description of mechanics of squeeze-out merger, including triangular merger).

  Squeeze-out mergers are common in leveraged corporate takeovers. After acquiring a voting majority, acquirers (whether in a friendly or unfriendly takeover) often use a squeeze-out merger to consolidate control, thus giving them unfettered access to corporate assets to repay their takeover debt.
- **Liquidation.** The subsidiary sells all of its assets to the parent (or an affiliate) and then dissolves and is liquidated. Minority shareholders receive a pro rata distribution of the sales price.
- **Stock split.** The subsidiary declares a reverse stock split (such as 1 for 2,000) that greatly reduces the number of outstanding shares. If no minority shareholder owns more than 2,000 shares, all minority shareholders come to hold fractional shares, which are then subject to mandatory redemption by the subsidiary as permitted under some state statutes.

These transactions (generically referred to as "squeezeouts" or "freezeouts") are all authorized by corporate statutes but present a clear conflict of interest.

In each instance the parent will want to minimize its payment to the minority shareholders. The minority is particularly vulnerable because the parent both controls the subsidiary's board and has voting power to approve the transaction over the minority's opposition. Despite the potential for abuse, squeezeouts present the opportunity for important efficiencies. By eliminating minority shareholders, the parent can (1) use the subsidiary's assets as it pleases, (2) consolidate the businesses for tax and accounting purposes, (3) avoid reporting and disclosure costs under federal securities laws, and (4) resell the wholly-owned subsidiary to another holding company. In short, depending on the price to minority shareholders, the subsidiary may be worth more to the parent if wholly owned.

§17.3.2 Business Purpose Test

A squeezeout terminates the minority shareholders' investment without their consent. Some courts require that the transaction not only be fair, but the parent also have some business purpose for the merger—other than eliminating the minority. See *Alpert v. 28 Williams Street Corp*., 473 N.E.2d 19 (N.Y. 1984); *Coggins v. New England Patriots Football Club, Inc*., 492 N.E.2d 1112 (Mass. 1986).

The business purpose test has been widely criticized as weak and easily manipulated. It imposes little substantive protection for minority shareholders because management can always create a record of avowed purposes for the squeezeout, such as greater operational or financial efficiencies, accounting simplicity, or tax advantages. At most, the business purpose requirement may sometimes distinguish between those squeeze-out mergers motivated by pique and those meant to create genuine gain.

Delaware has abandoned the business purpose requirement on the grounds it provides no meaningful protection beyond that afforded by the "entire fairness" test (see §17.3.3 below) and shareholder appraisal rights (see §17.3.4 below; Chapter 37). *Weinberger v. UOP, Inc*., 457 A.2d 701 (Del. 1983), *overruling Singer v. Magnavox Co*., 380 A.2d 969 (Del. 1977).

§17.3.3 "Entire Fairness" Standard

Weinberger v. UOP

In Delaware squeeze-out mergers are subject to a two-prong *entire fairness* test. *Weinberger v. UOP, Inc*., 457 A.2d 701 (Del. 1983). The test focuses on the fairness of both the transaction's price and the process of approval.

- **Fair price.** The *Weinberger* court characterized *fair price* as the preponderant consideration and liberalized Delaware's valuation methods for determining fair price in the context of a merger. It rejected the exclusivity of the *Delaware block method*, which gave a particular weight to historic earnings per share, asset value per share, and market price, and then added them together to produce a share price. Instead, the court held that valuation must take into account "all relevant factors," including discounted cash flow. The *discounted cash flow method*, generally used by the investment community to value companies, looks at the company's anticipated future cash stream and then, after making assumptions about risk-free interest rates and company risk, figures how much present cash would produce that future stream. The present cash value represents how much the business is worth.
- **Fair dealing.** The court described *fair dealing* as relating to "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." The court strongly recommended the subsidiary board form an independent negotiating committee of outside directors to act as a representative of the minority shareholders.

In *Weinberger*, minority shareholders of UOP challenged a cash-out merger at $21 per share that had been initiated by the parent Signal. The court faulted the procedures by which the merger had been initiated, negotiated, and approved—principally Signal's failure to disclose to UOP's outside directors or shareholders a feasibility study prepared by two of UOP's management directors, who were also executives of Signal. The study concluded that a price of $24 per share would have been a "good investment" for Signal. The court also found other deficiencies: Signal had initiated and structured the merger; there were no meaningful negotiations with UOP's outside directors; and the shareholders were not told that an investment banker's fairness opinion on the $21 price was based on a hurried and cursory review of the

company. In all, the merger failed the fair dealing test, and the court remanded for the Chancery Court to reconsider whether the $21 price was fair and order appropriate relief in view of the procedural unfairness.

Post-*Weinberger* "Fair Dealing" Cases

Since *Weinberger* the Delaware Supreme Court has clarified some aspects of the "fair dealing" test and what constitutes procedural fairness. The Court has considered the independence of the subsidiary's negotiating committee, how the parent conducted the negotiations, and whether a majority of the subsidiary's minority shareholders approved the transaction.

Negotiation by a team or special committee of the subsidiary's independent directors significantly buttresses procedural fairness, particularly when the directors are well informed and negotiations are "adversarial." *Rosenblatt v. Getty Oil Co*., 493 A.2d 929 (Del. 1985). This is so even though the outside, nonmanagement directors are chosen by the parent.

- **Shift of burden.** Negotiation and approval of the transaction by a committee composed of independent directors shifts the burden to the challenger to show lack of entire fairness. *Kahn v. Lynch Communication Sys., Inc. (Lynch I)*, 638 A.2d 1110 (Del. 1994) (rejecting business judgment review since controlling shareholder has inherent potential to coerce or unduly influence shareholder vote in merger). Merely initiating a merger or failing to obtain unanimous committee approval does not negate a finding of fair dealing.
- **Informed, independent committee.** The committee members must be independent and become fully informed, actively participate in deliberations, and appropriately simulate an arm's-length negotiation. *Kahn v. Tremont Corp*., 694 A.2d 422 (Del. 1997) (faulting independence of committee members, who all received significant compensation or influential positions on parent's controlled companies; faulting failure to attend information meetings with committee advisors; faulting lack of independent analysis of company's market and reliance on parent projections); *Lynch I* (concluding that parent's threat to proceed with hostile tender offer if merger proposal not accepted compromised arm's-length negotiation with independent committee).

The parent must conduct the negotiations fairly, though at arm's length—remember that the parent's management also has fiduciary duties to the parent corporation and its shareholders.

- **Timing of transaction.** A squeeze-out merger, although its share price is within a range of fairness, may not purposely be timed by the parent to avoid an obligation to pay a higher contract price. *Rabkin v. Philip A. Hunt Chemical Corp*., 498 A.2d 1099 (Del. 1985). The merger cannot blatantly advance the parent's interest at the expense of the minority shareholders'—a lingering business purpose analysis.
- **Disclosure during negotiations.** The parent need not disclose internally prepared valuations (its reservation price) unless directors or officers of the subsidiary prepare them. *Rosenblatt*. Only when executives have overlapping roles must the parent show its cards.

Approval by a majority of the subsidiary's minority shareholders, after full disclosure, buttresses (but does not guarantee) procedural fairness and shifts the burden to the challenger to show a lack of entire fairness. *Lynch I* (requiring court review of merger's procedural and price fairness to overcome perception of coercion in any squeeze-out merger). For this reason, it is advisable to condition the merger on approval by a specified "majority of the minority," even though such approval is not required.

Post-*Weinberger* "Fair Price" Cases

Although *Weinberger* held that appraisal (the post-merger procedure whereby the court sets a "fair value" payable in cash for the shares of dissenting shareholders, see Chapter 37) is normally the exclusive remedy for a challenge of the price in a squeeze-out merger (see §17.3.4 below), Delaware courts have clarified the "fair price" analysis:

- **DCF not exclusive.** The price paid to minority shareholders, if supported by an outside fairness opinion and asset valuations by outside experts, can be calculated using the old Delaware block method. Valuation based on discounted cash value is not exclusive. *Rosenblatt*.
- **Range of fair value.** Fair value can be based on opinions of the parent's

investment banker, even though the subsidiary's committee has received opinions of higher value from other investment bankers. *Kahn v. Lynch Communication Sys., Inc. (Lynch II)*, 669 A.2d 79 (Del. 1995) (when parent bears burden of showing entire fairness, parent must come forward with credible, persuasive evidence of "fair value" under recognized valuation standards; holding that trial court properly found parent's valuation more persuasive than challenging shareholder's).

- **Post-transaction projections (sometimes) relevant.** Price fairness must take into account "all relevant factors." Although "speculative elements of value" arising from the merger are excluded, nonspeculative *pro forma* data and projections "susceptible of proof" as of the date of the merger may be considered. *Weinberger*. This means the parent must share with the minority shareholders any financial, operational, or tax gains expected in the merger. *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289 (Del. 1996) (accepting valuation in appraisal based on actual results of acquirer's partially implemented business plan, not limited to premerger strategy).

Return to "Business Judgment Rule"

As applied by the Delaware courts, the *Weinberger* "entire fairness" standard places the burden on the defendants to show the transaction was "entirely fair." This high burden makes dismissal on summary judgment unlikely and creates incentives for plaintiffs' attorneys to challenge deals, whatever their merits, to elicit fees from defendant corporations. In 2014, responding to this trend, the Delaware Supreme Court reconsidered its standard of review in squeeze-out mergers—particularly, back-end mergers effectuated after a successful tender offer. *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

In *Kahn*, the court sought to readjust the incentives in "deal litigation" by holding that the business judgment standard of review would apply to any squeeze-out merger in which:

(1) an independent special committee of the corporation's board, empowered to select its own advisors and able to reject the controlling shareholder's offer, negotiates the transaction, and

(2) an un-coerced, informed majority of the minority shareholders approves the transaction.

Thus, *Kahn* attempts to reduce frivolous challenges to back-end mergers. Whether the case will produce the desired result has yet to be seen. Both the independent-committee and majority-of-minority inquiries are fact-dependent and necessitate extensive pre-trial discovery, thus encouraging plaintiffs' attorneys to continue to challenge back-end deals to obtain fee awards.

Short-Form Mergers

When a parent corporation eliminates minority shareholders using the procedure of a "short-form" merger (available to parents owning at least 90 percent of the subsidiary's shares), courts have limited complaining shareholders to an appraisal remedy. *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001). It would defeat the summary nature of the short-form merger procedure (see §36.2.3) if the parent had to constitute a negotiating committee of subsidiary directors, hire independent financial and legal experts, and conduct an arm's-length negotiation. Nonetheless, minority shareholders who face the choice of accepting the merger terms or seeking an appraisal must receive full disclosure.

An open question remains whether the same limitation applies to the streamlined process for back-end, squeeze-out mergers available to acquirers holding a *majority* of the corporation's shares, though less than the 90 percent necessary for a short-form merger. See Del. GCL §251(h) (added in 2013). The logic of this new procedure—which recognizes that minority shareholder voting rights are illusory given the power of the majority shareholder to effectuate the merger regardless of their vote—suggests that shareholders squeezed out under the streamlined procedure of §251(h) would be limited to appraisal rights, subject to their rights to full disclosure. See §36.2.4

§17.3.4. Remedy in Squeeze-outs

The traditional remedy for unfair self-dealing—rescission of the transaction — often is not possible in a squeeze-out. A squeeze-out fundamentally changes the corporate structure, and returning the corporation and its shareholders to their prior position may be impractical.

Appraisal (Sometimes) Exclusive

Even if minority shareholders prove the squeeze-out is unfair, however, they are not necessarily entitled to recover damages. *Weinberger* held that

dissenters' appraisal rights (see Chapter 37) are normally the exclusive remedy when a squeeze-out merger is challenged on the basis of price. But when a merger is challenged on the basis of fraud, misrepresentation, self-dealing, deliberate waste, or palpable overreaching—that is, a lack of *fair dealing*—the *Weinberger* court stated that appraisal would not be exclusive. See also Official Comment, MBCA §13.02 (appraisal is exclusive unless the transaction is "unlawful or fraudulent," which includes violation of corporate law on voting or of the articles, deception of shareholders, and fiduciary breach). Thus, appraisal is exclusive when only price is challenged, but not when procedural fairness or the adequacy of disclosure is challenged.

Consolidated Proceedings

What happens if shareholders bring an appraisal proceeding and during discovery learn for the first time of procedural irregularities in the merger? Is appraisal still the exclusive remedy? The Delaware courts have permitted shareholders in these circumstances to bring a separate, alternative claim challenging the merger on procedural grounds. See *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988). That is, the election of remedies is not exclusive, and both a properly pleaded appraisal action and procedural fairness action can proceed simultaneously on a consolidated basis. But the plaintiff is limited to a single recovery, which can be based either on fair value in appraisal or rescissory damages in the fairness action.

Director Liability

Most challenges to parent-subsidiary mergers, though often couched in terms of director duties, rarely result in actual director liability. Instead, liability usually runs to the parent corporation—the beneficiary of unfair dealing or an unfair price. To the extent subsidiary directors fail in their negotiation duties, exculpation provisions in the subsidiary's charter typically insulate them from liability. See §12.5. A few cases, however, have imposed liability on directors. For example, the Delaware Chancery Court has held that directors of a partially-owned subsidiary jointly and severally liable in a "going-private" transaction orchestrated by the company's 52 percent parent. *In re Emerging Communications, Inc. Shareholders Litigation*, 2004 WL 1305745 (Del. Ch. 2004). After determining the process and price in the transaction were seriously flawed, the court held three directors liable: the subsidiary's CEO (who was also a part owner of the parent company), the subsidiary's

legal counsel (who was also the CEO's personal attorney), and an outside director (who had extensive experience as an investment advisor in the telecommunications sector).

The court concluded that the CEO had breached his duty of loyalty by being on both sides of the unfair transaction, the lawyer had breached his duty of loyalty and/or good faith by assisting the CEO in furthering his "antithetical" interests, and "with reluctance" concluded that the outside director who seemed to know the merger price was unfair had breached his duty of loyalty. Other directors on the board, though careless in relying on a flawed outside valuation opinion, were not held liable because of the subsidiary's exculpation clause under Del. GCL §102(b)(7).

The implication of *Emerging Communications* is that directors with conflicting financial interests act at their own peril when pursuing a transaction whose process or terms are later deemed unfair. More significant, the case suggests that directors with greater financial expertise bear a higher fiduciary duty to recognize and oppose a transaction that they "have strong reasons to believe" is financially unfair. In such circumstances, a director who seeks to ingratiate himself with conflicted insiders, who has "unique knowledge" that the transaction is unfair, and who "intentionally disregards" his responsibility to minority shareholders, violates his duty of good faith. See *Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006) (holding that directors who consciously disregard their responsibilities violate duty of good faith, a subset of duty of loyalty).

§17.3.5 Fairness in Parent Tender Offer

A parent corporation can also squeeze out minority shareholders of a partially controlled subsidiary through a two-step process: (1) a tender offer to bring the parent's holdings to more than 90 percent of the outstanding shares, and (2) a short-form merger in which the remaining minority shareholders are bought out and appraisal is their exclusive remedy. (A tender offer is a contractual offer to buy shares at a specified price, provided they are tendered for sale by a specified deadline. See §34.1.) Not only does this method (compared to a squeeze-out merger) avoid action by the subsidiary's board, but it also avoids questions of the fairness of the dealing and price for the shareholders who tender their shares in the first-stage tender offer.

Delaware courts have struggled with this anomaly. One view assumes

shareholders (particularly institutional investors) can fend for themselves in a parent tender offer. If the tender offer provides minority shareholders a fully informed, voluntary choice, the Delaware courts have refused to impose any right "to receive a particular price." See *Solomon v. Pathe Communications Corp.*, 672 A.2d 35 (Del. 1996) (rejecting entire fairness review).

Another view is that the same "800-pound gorilla's retributive capabilities" that justify heightened judicial review in squeeze-out mergers, even when approved by a majority of the minority, argue for "some equitable reinforcement" in parent tender offers. According to the Delaware Chancery Court, for a parent tender offer not to be coercive, the offer must (1) be subject to a "majority of minority" tender condition, (2) include a promise to engage in a prompt back-end merger at the same price as the tender offer, and (3) not involve retributive threats. See *In re Pure Resources, Inc. Shareholders Litigation*, 808 A.2d 421 (Del. Ch. 2002) (imposing conditions to minimize distorting influence of tendering process on voluntary choice).

Examples

1. Yankee Holdings is a diversified conglomerate. One of its wholly-owned subsidiaries, Yankee Air, operates a passenger and cargo airline with its main hub in Appleton. Holdings also owns Yankee Shipping, a commercial shipper in the United States and abroad. Under a contract with Yankee Shipping, Yankee Air provides air transportation services at rates significantly below those available from other airlines. All companies are incorporated in an MBCA jurisdiction.
   a. Most of Yankee Air's directors are officers of Holdings. Is the shipping contract subject to challenge?
   b. Yankee Air becomes insolvent because of the burdensome contract with Shipping. Can Yankee Air's creditors hold Holdings liable on a self-dealing theory?
2. To finance its expansion into new markets, Yankee Holdings issues common stock to public investors. After the public offering, public shareholders hold 20 percent of Yankee Air's outstanding stock. In its expansion, Yankee Air acquires new aircraft under long-term leases with Holdings. Under the arrangement, Holdings owns the aircraft and charges Yankee Air above-market rates for leasing them. Despite this financial burden, Yankee Air becomes highly profitable and issues a large stock

dividend because Holdings needs cash.

a. The Yankee Air board, composed mostly of Holdings' officers, remains unchanged after the public offering. Is the leasing arrangement subject to challenge?
b. The dividend is legally permissible, but weakens Yankee Air's ability to expand further. Is the dividend subject to challenge?

3. Holdings abandons its captive-lease strategy and allows Yankee Air to acquire aircraft from other companies. Yankee Air purchases aircraft and earns investment tax credits (ITCs) when it makes the purchases. (ITCs entitle their holder to reduce corporate income tax by the amount of the credit.) Holdings and Yankee Air agree to continue filing a consolidated tax return, which allows a parent corporation to include the income, deductions, and credits of any 80 percent subsidiary in a single consolidated return. Holdings files a consolidated return, and Yankee Air's ITCs reduce Holdings' total tax liability by $10 million. Yankee Air did not have any taxable income itself and, under the tax law, could not have used the ITCs.
   a. Under Delaware's approach to parent-subsidiary business dealings, must Holdings share this tax savings with Yankee Air?
   b. Under the judicial "equal treatment" approach, must Holdings share with the subsidiary shareholders the value of its tax savings?
   c. Under the MBCA's liability provisions, are the Yankee Air directors liable for approving a one-sided arrangement with Holdings?
   d. Yankee Air's prospectus had told investors that Holdings would continue to file a consolidated tax return after the public offering and that Holdings might use ITCs generated by Yankee Air in its consolidated return. Does this make any difference in deciding whether Holdings must share?
4. Francis, an outside director of Yankee Air, learns that Lone Star Airways is planning to sell its once profitable air routes at bargain prices. She suggests to Charles, the Holdings CEO, that the Yankee group buy the Lone Star routes. Charles agrees, confident the new routes will be highly profitable for Yankee Air. Holdings proposes a merger with Yankee Air in which minority shareholders will receive $50 per share, a 30 percent premium over market. Frances is the only Yankee Air director who knows the squeeze-out will allow Holdings to profit fully once Yankee

Air acquires the Lone Star routes. Which of the following insulates the merger from review in a challenge by a minority shareholder?

a. Holdings does not disclose its interest in the Lone Star routes to the Yankee Air board or shareholders.

b. The Yankee Air board forms a committee of outside directors (not including Frances) to consider the merger. The committee in turn hires its own outside lawyer and investment banker to advise it.

c. The committee asks First Lynch Securities to opine whether $50 is a fair price for Yankee Air's shares, based on *current* earnings projections using a discounted cash-flow analysis.

d. The committee concludes it will be easier for a combined Holdings—Yankee Air entity to attract financing than the current partially-owned structure. The committee recommends the merger as proposed.

e. The Yankee Air board conditions the merger on the approval of a majority of the minority shares, though without disclosing the possibility that Yankee Air might buy the Lone Star routes.

5. Holdings and Yankee Air take all these actions, and the Yankee Air shareholders approve the merger. Mildred, a minority Yankee Air shareholder, sues on behalf of Yankee Air shareholders who voted for the merger and received the $50 merger price. (Many shareholders who did not vote for the merger have sought appraisal.)

a. Who should be the defendants?

b. What must the defendants show to withstand this challenge?

c. Mildred seeks to have the merger rescinded. Is the court likely to rescind?

d. Mildred claims the $50 merger price was unfair. She says that today Yankee Air is worth at least $65 per share after its acquisition of the Lone Star routes. Is the court likely to award $15 in damages? On what theory?

Explanations

1. a. No. Who is hurt and who would attack it? Yankee Air has no minority shareholders, and its board is controlled by its parent, Holdings. Although the shipping contract is self-dealing by Holdings and by the

Yankee Air directors, it is not subject to fairness review. One of the benefits of complete ownership is the flexibility for the parent to choose profit centers—in this case Yankee Shipping.

b. Perhaps. Under a theory that fiduciaries' duties to the corporation encompass duties to creditors that may be asserted on corporate insolvency, the creditors (or their representative) could claim a breach of Holdings' duty of loyalty to Yankee Air. In effect, the claim would be that Holdings was enriching itself at creditor expense through self-dealing. Whether the self-dealing was unfair may turn on whether Holdings disclosed to creditors its arrangements with Yankee Air (see §13.3.4). If the self-dealing was undisclosed to creditors, Holdings might also be held liable on a "piercing the corporate veil" theory (see §13.2.8).

2. a. Yes. Minority shareholders of Yankee Air could bring a derivative suit challenging the arrangement as a breach of Holdings' fiduciary duty to Yankee Air and its minority shareholders. See *Sinclair Oil Co. v. Levien*, 280 A.2d 717 (Del. 1971). The leasing arrangement is substantively unfair by being above market prices.

The arrangement is also nominally a "director's conflicting interest transaction" because of the interlocking position of some Yankee Air directors as officers of Holdings. See MBCA §8.60(1)(ii) (transaction brought before the board and director is employee of other party). Nonetheless, the MBCA safe harbor provisions are not meant to apply to this parent-subsidiary transaction. See Note on Parent Companies and Subsidiaries, MBCA §8.60 ("better approach" to deal with parent-subsidiary transactions under rubric of duties of controlling shareholder). As in Delaware, the MBCA focus is on the parent corporation's role in recognition that the subsidiary directors are unlikely to exercise meaningful independent judgment.

b. It depends. On its face, the declaration of dividends did not prefer Holdings since minority shareholders also received their pro rata share. Nonetheless, the parent may have put its cash needs ahead of the subsidiary's expansion potential. Were the dividends a parental preference or a business decision protected by the business judgment rule? The MBCA standards of liability for directors address this question by imposing liability on directors for a "lack of objectivity"

due to the domination or control of an interested person. MBCA §8.31 (adopted 1997). The focus would be on whether the subsidiary directors' position as Holdings officers could reasonably be expected to affect their judgment and whether they can establish nonetheless that they reasonably believed the dividend was in the best interest of the subsidiary. That is, the MBCA's liability provisions look to director independence.

The prevailing judicial approach, reflected in Delaware cases, focuses on whether the parent was motivated to prefer itself at the expense of minority shareholders. In our example this would be a difficult showing since the minority shareholders shared pro rata, and any injury to the subsidiary's business was borne more heavily by Holdings than by minority shareholders. If the transaction were characterized as a preference, Holdings would have the burden to show a compelling business purpose for having the subsidiary declare the high dividends. This may be difficult because there are suggestions Yankee Air would have been better off with access to the internally generated capital. In the end, under the prevailing judicial approach, the minority faces a difficult burden to show the dividends preferred the parent.

3. a. Probably not. Holdings did not prefer itself to the detriment of minority shareholders, it could be argued, since the ITCs in Yankee Air's hands were of little or no value—Yankee Air did not have enough taxable income to have used them. Tested under the business judgment rule, the ITC-sharing by Yankee Air passes muster if the subsidiary received some consideration for the ITCs. (The ITCs have some value since they could conceivably be used in the future under IRS carryforward rules—which allow credits that are unusable in one year to be used in future years when there exists taxable income—or if Yankee Air were sold to a company able to use the ITCs.) The calculation of a present value for this future, speculative value would be left to the discretion of the Yankee Air board. The prevailing judicial approach allows a parent corporation to exploit its control. But see *Case v. New York Central R. Co.*, 256 N.Y.S.2d 607 (N.Y. 1965) (requiring parent of partially-owned subsidiary to share tax benefits realized through filing consolidated tax return).

b. Probably. Under the "equal treatment" analysis of *Ahmanson*, the court

strictly protects the minority shareholders' interests and prevents the controlling shareholder from using its control to prefer itself. (There is some question whether *Ahmanson* applies to parent-subsidiary dealings not involving discrepant treatment of the minority's shares.) Under this approach, a court would require a showing of a "compelling business reason" for Yankee Air to give up the ITCs without receiving their value to Holdings. Unless the uncompensated sharing were shown to be necessary to Yankee Air—for instance, to keep Holdings as a source of future below-market financing—the court probably would require that Holdings pay the full value of the ITCs. This approach attaches little value to Holdings' control position or the prerogatives that come from control. In fact, rather than treat the subsidiary as an outside party in which negotiation would presumably lead to some sharing of the ITCs' value, the parent could be obligated to prefer the subsidiary.

c. Perhaps. The MBCA's new director liability provisions change the focus from the parent to the subsidiary's board. See MBCA §8.31(a)(2)(3) ("lack of objectivity" of controlled director). Although this new liability standard does not explicitly refer to parent-subsidiary dealings, it does contemplate that a director's employment by a related person triggers increased review. See Official Comment, MBCA §8.31(a). If shown to be nonindependent, the director must establish his reasonable belief in the transaction's *fairness to the corporation*. The giving to another of tax advantages, without negotiating some sharing of their value, would seem not to be an arm's-length transaction. This conclusion holds particularly for directors with special expertise. See *In re Emerging Communications, Inc. Shareholders Litigation*, 2004 WL 1305745 (Del. Ch. 2004) (see §17.3.4).

d. Yes. Under each approach, the disclosure of the ITC-sharing policy and the shareholders' awareness (or at least the pricing of their shares to reflect it) undermines any claim of unfairness to the minority. The knowing purchase (and pricing) of Yankee Air shares, both in the offering and in the trading market, arguably has the effect of implicit consent. Arguably, the policy is not even subject to waste review.

4. a. Does not insulate. In general, the parent need not disclose its motives and purposes. The management of the parent corporation has fiduciary duties to the parent's shareholders to achieve a favorable transaction.

Nondisclosure in this case, however, creates two problems. First, Holdings will be responsible for any procedural unfairness on the Yankee Air board, including if Frances knows of the parent's interest in the Lone Star routes and fails to disclose this to the Yankee Air board and shareholders. *Weinberger*. Second, the parent cannot use control to prefer itself. Although it is unclear whether the Lone Star routes are corporate opportunities of Yankee Air, their possibility seems to be behind Holdings' desire to consolidate control. Holdings should be prepared to disclose this interest and pay for the potential value it creates for Yankee Air.

b. Helps insulate. If Yankee Air's minority shareholders are represented by a board committee composed of outside and independent directors, a court might review the merger as an arm's-length transaction. See *Weinberger*. Not only should the committee members be outside directors—neither executives of Yankee Air nor directors or executives of Holdings—they should also be independent. Cases since *Weinberger* make clear that committee members should not have any current or past financial relationships with the controlling shareholder that would compromise their independence. *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997) (finding lack of independence of committee members who had served as paid consultants to affiliates of controlling shareholder).

Once properly composed, the committee should hire outside counsel and an investment banker, neither of whom should have any preexisting relationship with Holdings or Yankee Air. See *Kahn v. Tremont Corp.* (criticizing committee choice of lawyer recommended by inside counsel and investment advisor that had earned significant fees advising affiliates of controlling shareholder). The outside directors should be unhurried and fully inform themselves about, among other things, options for Yankee Air in the future—including adding new routes.

A properly composed and advised committee, while assuring protection of minority shareholders' interests, may also benefit Holdings. The independent committee structure allows Holdings' management to negotiate aggressively, consistent with management's duties to the Holdings shareholders. Cf. *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110 (Del. 1994) (criticizing controlling shareholder's threat of hostile tender offer).

c. Might help insulate. The opinion gives the committee objective information on fair value. The discounted cash flow method provides a valuation of a company's cash-generating worth. It anticipates a future earnings stream and calculates how much cash today would be necessary (making some assumptions about future interest rates) to generate that same stream. The Delaware courts now accept this as a legitimate, though not exclusive, means of valuing a company.

   Nonetheless, the opinion may not be as valuable if it does not include the future potential value of new air routes. The investment banker's failure to consider this potential future cash flow would undermine the reliability of the opinion.

d. Not help insulate. The committee should be considering the fairness to minority shareholders. It is not acting for Holdings. Whatever Holdings' business purposes, the committee must act as an arm's-length negotiator on behalf of Yankee Air's minority shareholders.

e. Not help insulate. In general, conditioning the merger on approval by a majority of the minority shareholders—that is, more than 50 percent of the public shareholders (20 percent)—bolsters the validity of the self-dealing transaction, *if the shareholders are fully informed*. See *Kahn v. M&F Worldwide* (adoption by independent board committee, along with approval by majority of minority shareholders, insulates transaction under business judgment rule); *Lynch I* (informed minority shareholder approval shifts burden to challenger to show transaction was not entirely fair). In this case, the failure to disclose the potential value to Yankee Air of possible new routes undermines the value of minority approval. Although Holdings need not discuss all its plans, it must describe plans that would have a material effect on price and that are known to the subsidiary's board. Holdings' interest in the squeeze-out suggests the possibility of obtaining the Lone Star routes is of actual importance to it. Frances's knowledge of the possibility compels her and the Yankee Air board to disclose this material information to the minority shareholders.

5. a. Holdings, as controlling shareholder, and the directors of Yankee Air. Until recently, the cases have placed principal responsibility with the controlling shareholder to ensure entire fairness to the minority shareholders. Although the corporation's board has significant

responsibilities in protecting minority interests, liability has typically been assessed against only the parent. This may, however, be changing—particularly in view of the "good faith" analysis that forbids outside directors from "intentionally disregarding" minority interests. See *In re Emerging Communications, Inc. Shareholders Litigation*, 2004 WL 1305745 (Del. Ch. 2004) (§17.3.4).

b. The MBCA is unclear. A squeeze-out merger is a conflict-of-interest transaction in which minority shareholders are treated differently from the controlling shareholder. The minority receives the consideration (cash or other securities) specified in the merger agreement, and the controlling shareholder retains its equity ownership or acquires the subsidiary as a new division. The MBCA does not specify what standard applies to parent-subsidiary mergers. See Note on Parent Companies and Subsidiaries, MBCA §8.60(1) (stating that safe harbor provisions for director's conflicting interest transactions have "no relevance" to parent-subsidiary transactions).

Nonetheless, most courts permit such transactions provided they are fair to the minority. Under an entire fairness standard, the defendants would have to show both the price and the dealings were fair. This would be difficult if Frances failed to disclose her knowledge of Holdings' plans to acquire the Lone Star routes. Nondisclosure would affect price fairness and taint any negotiations if Frances withheld this information from Yankee Air.

c. No. Undoing the transaction would force shareholders to repurchase their shares at the merger price. The court would also have to rescind any postmerger transactions between Holdings and Yankee Air, and perhaps with third parties. Courts generally view postmerger rescission as unworkable.

d. Perhaps—on a disclosure theory. The MBCA states that appraisal is exclusive unless the merger was unlawful or fraudulent. MBCA §13.02 (see §37.3). If the court invalidates the merger as fraudulent, the usual remedy is rescissory damages—that is, what the shares would be worth if the merger had not happened. See *Weinberger*. This permits shareholders to recover the difference between the postmerger value of the company and the $50 merger price. In this case, if the shares are worth $65 because of postmerger events, whose possibility was

improperly concealed in the merger, rescissory damages would be $15.

CHAPTER 18

Shareholder Litigation

Two litigation techniques are available to shareholders to vindicate their interests in the corporation. Shareholders can sue in their own capacity to enforce their rights as shareholders (a direct action, usually brought as a class action), or they can sue on behalf of the corporation to enforce corporate rights that affect them only indirectly (a *derivative action*). How one characterizes the suit affects a number of things: who pays for litigation expenses, who recovers, what procedures apply to the shareholder-plaintiff, and whether the suit can be dismissed by the corporation. Derivative litigation is the principal means by which shareholders enforce fiduciary duties.

This chapter describes the nature of a derivative suit (§18.1) and how it is distinguished from a direct suit (§18.2), the derivative-suit procedures applicable in state court (§18.3) and the special procedures in federal court (§18.4), and the dismissal of derivative suits, by the board or by a special board committee (§18.5).

§18.1 Nature of Derivative Litigation

The derivative suit is nineteenth-century equity jurisdiction's ingenious solution to the dilemma created by two inconsistent tenets of corporate law: (1) corporate fiduciaries owe their duties to the corporation as a whole, not

individual shareholders, and (2) the board of directors manages the corporation's business, which includes authorizing lawsuits in the corporate name. Derivative litigation breaks the stranglehold the board would otherwise have over fiduciary accountability.

In a derivative suit, a shareholder sues *on behalf of the corporation*. Without this procedure, management's fiduciary duties to the corporation would be virtually meaningless if the board's power extended to all litigation decisions. It would be the rare case that managers would choose to sue themselves.

Note on Derivative Litigation in LLCs

Derivative suits are also authorized in LLCs for members who want to vindicate the rights of the LLC, particularly based on claims that managers or other members have breached their fiduciary duties. See ULLCA §1101 (provided "members or managers having authority to do so have refused to commence the action"). Even when the LLC statute is silent, courts have permitted LLC members to bring derivative litigation on behalf of the LLC. See *Tzolis v. Wolff*, 884 N.E.2d 1005 (N.Y. 2008).

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§18.1.1 Two Suits in One

In a derivative suit, shareholders sue on behalf of the corporation to enforce rights of the corporation. It is in effect two suits in one. In theory, the shareholder (1) sues the corporation in equity (2) to have the corporation bring an action to enforce corporate rights, such as when there is a breach of fiduciary duties by corporate officials. Although the modern derivative suit is treated as one action, the historical notion of two suits survives. The corporation, an indispensable party, is made a nominal defendant. The corporation—that is, the board of directors and management—can compel the derivative suit plaintiff to comply with various procedural requirements (see §18.3 below).

The "two suits in one" notion spawns some procedural effects. For example, federal jury trial rights arise if they would have existed in a suit by the corporation, generally when the suit seeks damages. *Ross v. Bernhard,* 396 U.S. 531 (1970). (Many states have different jury trial systems; in

Delaware, for example, the chancery court hears all corporate law actions, whether direct or derivative, without a jury.) In addition, the court must have personal jurisdiction over the individual defendants. See *Shaffer v. Heitner*, 433 U.S. 186 (1977) (holding *quasi in rem* action based on sequestration of defendant directors' shares in Delaware corporation insufficient to create personal jurisdiction). Many states, including Delaware, now have statutes that treat acceptance of a directorship as consent to jurisdiction in the state. See *Armstrong v. Pomerance*, 423 A.2d 174 (Del. 1980) (applying 10 Del. Code Ann. §3114).

One consequence of the "two suits in one" notion is that the corporation —in the *articles of incorporation*—can choose the forum in which derivative litigation must be brought on its behalf. See *In re Revlon, Inc. Shareholders Litigation*, 990 A.2d 940 (Del. Ch. 2010) (holding that corporate charter can include forum-selection provision specifying exclusive forum for intracorporate disputes).

Whether the corporation's *bylaws* can include a forum-selection provision adopted by the board has been controversial. How can shareholders be forced to sue in a forum unilaterally selected by the board? In 2013, the Delaware chancery court upheld a board-passed, forum-selection bylaw, even though shareholders had not given their approval. See *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2014) (Strine, Chancellor). The court concluded that the bylaw, which required that all suits involving "internal corporate governance" be brought in Delaware state or federal court, was not invalid under Delaware's corporate statute, given that it related to "the business of the corporation, the conduct of its affairs, and … the rights or powers of its stockholders, directors, officers or employees." See Del. GCL § 109(b). In addition, the court explained that the shareholders were "on notice" that the board could unilaterally change the bylaws and had essentially assented to this "contractual framework" established by Delaware's corporate law and the company's articles of incorporation.

Note on Litigation of Delaware Cases Outside of Delaware

One of the reasons for the recent interest in forum-selection provisions in the articles and bylaws of Delaware corporations has been the trend of shareholder-plaintiffs in Delaware corporations to bring their cases in

state and federal courts *outside* of Delaware. For example, nearly all large mergers and acquisitions (M&As) are now challenged in court by multiple plaintiff-shareholders, but mostly in non-Delaware courts. To avoid the forum shopping and "rush to settlement" that multi-jurisdiction litigation encourages, many corporate boards have turned to forum-selection bylaws—with Delaware as the specified forum—thus to consolidate all the claims in one court.

Even though cases involving Delaware corporations that are filed outside of Delaware remain subject to Delaware corporate law under the "internal affairs doctrine" (see §3.2.1), the problem has been that under principles of collateral estoppel the first case to be settled resolves all the claims involving the corporation and its officials. Often this first case is more weakly prosecuted than the other filed cases, resulting in a settlement that may be disadvantageous to the body of shareholders. In addition, many courts outside of Delaware—with less experience in shareholder litigation in the M&A context—are more inclined to award attorneys' fees and other legal expenses to shareholder-plaintiffs, compared to Delaware courts where judges have become more skeptical of the value added by litigation challenging M&A transactions.

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§18.1.2 All Recovery to Corporation

Derivative litigation enforces corporate rights. This means any recovery in derivative litigation generally runs to the corporation. The shareholder-plaintiff shares in the recovery only indirectly, to the extent her shares increase in value because of the corporate recovery. The shareholder-plaintiff also benefits indirectly by the deterrent value of an award or when equitable relief forbids or undoes harmful behavior.

Sometimes corporate liability is empty because the corporation is no longer in existence or because it would produce a windfall for new owners. Courts in these circumstances have allowed injured shareholders to recover directly in proportion to their holdings. See *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955) (see §20.2.3); *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975) (see §27.2.2). The ALI Principles of Corporate Governance suggest that when derivative litigation involves a close corporation a court may exercise its discretion to allow direct shareholder

recovery, provided the corporation is not exposed unfairly to multiple claims, creditors are not materially prejudiced, and the recovery can be fairly distributed. ALI Principles §7.01(d).

§18.1.3 Reimbursement of Successful Plaintiff's Expenses

Why would a shareholder, particularly a shareholder in a public corporation, undertake the effort and expense of a derivative suit? The answer is simple and troubling: the corporation reimburses the attorney fees of the successful plaintiff. Contrary to the prevailing American rule that each litigant bears his own litigation expenses, the universal rule in derivative litigation is that the court will order the corporation to pay the successful plaintiff's litigation expenses, including attorney fees. See MBCA §7.46(1) ("if … the proceeding has resulted in a substantial benefit to the corporation"). The theory is that the successful plaintiff (and her attorney) have produced a benefit to the corporation, and thus they should be reimbursed for their effort.

Effect of Rule

The engine driving the derivative suit in public corporations is the plaintiff's attorney—a "bounty hunter" for the corporation whose fees are contingent on an award by the court or in a settlement. Notice how the attorney is the real plaintiff in interest: The attorney often brings the possibility of a lawsuit to the shareholder-plaintiff's attention; the attorney usually runs the litigation; the attorney typically has the greatest stake in the outcome; and the attorney decides when and whether to settle the litigation, often depending on the level of attorney fees provided in the settlement offer.

Corporate law deals with this alarming reversal of the client-attorney roles by regulating the bringing and settlement of derivative litigation (see §18.3.4 below).

Method of Fee Calculation

Attorney fees in derivative litigation generally have been calculated using either a *percentage-of-recovery* or a *lodestar* method. Under the percentage-of-recovery method, the attorney receives a percentage of the corporation's recovery, varying between 15 and 35 percent depending on the size of the

recovery. Under the lodestar method, fees are based on the number of hours spent on the suit multiplied by the prevailing rate for similar legal work by an attorney of comparable experience and stature; this amount then may be adjusted upward or downward depending on the quality of work, the novelty of the issues, and the original likelihood of success. The lodestar method, unlike the increasingly used percentage-of-recovery method, creates an incentive for protracted litigation and discourages reasonable, prompt settlement.

§18.1.4 Derivative Suit Plaintiff— Self-Appointed Representative

In a derivative suit, the plaintiff-shareholder (with her attorney) chooses herself as a representative for the corporation. The possibility that the plaintiff will conduct the litigation for her own gain without serving the interests of the corporation or the shareholders as a group is evident. A shareholder (and her attorney) may bring a derivative suit solely as a nuisance to extract a settlement that primarily benefits themselves. For this reason, courts and statutes impose on the derivative suit plaintiffs a duty to be a faithful representative of the corporation's and the other shareholders' interests. See Fed. R. Civ. P. 23.1 (shareholder-plaintiff must "fairly and adequately represent the interests of the shareholders or members substantially similarly situated in enforcing the right of the corporation").

Shareholders are not the only parties who can bring a derivative suit. Creditors can bring derivative suits to enforce their claims against an insolvent corporation. *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (concluding that creditors cannot assert direct claim against insolvent corporation, but may assert derivative claims). In addition, some statutes permit an officer or director to bring a derivative action. See N.Y. Bus. Corp. Law §720(b). But absent express statutory authorization, directors and officers lack standing to sue derivatively in their capacity as a director or officer. See *Schoon v. Smith*, 953 A.2d 196 (Del. 2008).

§18.1.5 Res Judicata—Preclusion of "Corporate" Relitigation

Because in a derivative suit the shareholder-plaintiff sues on behalf of the corporation, the corporation becomes bound by any judgment or settlement. This means neither the corporation nor a subsequent derivative suit plaintiff can bring a suit based on claims that were raised in the derivative suit. By the same token, if the corporation itself has already litigated or settled in court a claim in good faith, res judicata prevents a shareholder from bringing a derivative suit making the same claim. Given this preclusive effect, shareholders who were not parties in a derivative suit may have a right to appeal any settlement, even though they did not intervene and object in the trial court. See *Devlin v. Scardelletti,* 536 U.S. 1 (2002) (federal class action).

The res judicata effect of a settlement of shareholder claims can reach beyond the claims before the court. For example, the U.S. Supreme Court has held that a settlement of a class action approved by a Delaware court could preclude ongoing federal claims involving the same corporation brought in a federal court in California. *Matushita Elec. Indus. Co. v. Epstein,* 516 U.S. 367 (1996). In the case, the Delaware court approved a $2 million settlement that released all claims involving a tender offer in which the bidder had entered into side agreements to acquire shares of the target's officers. The Supreme Court held that if the Delaware court's approval of the settlement satisfied due process (particularly, adequacy of representation), the settlement could preclude exclusively federal claims (potentially worth $2 billion) even though the Delaware court could not have acquired subject matter jurisdiction over them.

Suppose a shareholder's derivative suit is dismissed because the court determines the shareholder is not an adequate representative of the corporation. Can another (more adequate) shareholder then bring the same claim? In Delaware, the answer is yes. Even when the initial shareholder-plaintiff's claim is dismissed with prejudice because the shareholder did not conduct a meaningful investigation into a *Caremark* claim alleging that the board had failed to install a monitoring system to ensure corporate compliance, another shareholder can bring the same claim after undertaking a more thorough §220 "books and records" investigation (see §7.1.4). See *South v. Baker*, 62 A.3d 1 (Del. Ch. 2012) (citing prevailing view that "with-prejudice dismissal" not preclusive, if initial plaintiff failed to provide adequate representation).

§18.1.6 Time Limitation

Derivative claims typically involve claims of fiduciary breach. What is the applicable statute of limitations for such claims? Some courts view fiduciary breaches as sounding in tort and apply the relatively short two- or three-year limitations period applicable to tort actions. *Demoulas v. Demoulas Super Mkts.*, 677 N.E.2d 159 (Mass. 1997) (diversion of corporate opportunities and self-dealing). Other courts view the shareholder-corporation relationship as contractual and subject corporate fiduciary claims to the typically six-year statute of limitations applicable to contract claims. *Hanson v. Kake Tribal Corp.*, 939 P.2d 1320 (Alaska 1997) (discriminatory dividends).

In some states, claims of fiduciary breach are subject to specific statutes of limitations. See *Park City Mines Co. v. Greater Park City Co.*, 870 P.2d 880 (Utah 1993) (applying Utah statute that requires claims asserting liability against director or shareholder to be brought within three years). In Delaware, a three-year statute of limitations applies to damages actions arising from "an injury unaccompanied with force or resulting indirectly from the act of the defendant." Del. Code Ann. tit. 10, §8106. Delaware courts have interpreted the statute to apply to derivative actions seeking damages and to be tolled "until such time as a reasonably diligent and attentive stockholder knew or had reason to know of the facts alleged to constitute the wrong." *Kahn v. Seaboard Corp.*, 625 A.2d 269 (Del. Ch. 1993) (self-dealing). In derivative actions seeking equitable relief (such as a constructive trust or rescission of proxies), the Delaware courts have looked to the statutory period as "a presumptive time period for application of laches to bar a claim." *U.S. Cellular v. Bell Atlantic Mobile Systems, Inc.*, 677 A.2d 497 (Del. 1996).

§18.2 DISTINGUISHING BETWEEN DERIVATIVE, DIRECT, AND CLASS ACTION SUITS

A shareholder may also sue in her personal capacity to enforce her rights as a shareholder—a direct action. Unlike a derivative suit, a direct action is not brought on behalf of the corporation. To avoid the host of procedural requirements that apply to derivative suits, shareholders will often seek to characterize their suit as direct. For example, if state law requires a demand on the board (see §18.3.3 below), the characterization of the suit as derivative

or direct may practically decide its viability.

§18.2.1 Examples of Direct Suits

In many cases, the characterization is straightforward. Direct suits are those in which shareholders seek to enforce rights arising from their share ownership, as opposed to rights of the corporation. Direct suits include suits to

- enjoin ultra vires actions (see §3.3.3)
- compel payment of dividends declared but not distributed (see §4.1.3)
- compel inspection of shareholders' lists, or corporate books and records (see §7.1.4)
- require the holding of a shareholders' meeting, whether the board has violated statutory or fiduciary duties (see §7.2.1)
- challenge fraud on shareholders in connection with their voting, sale, or purchase of securities (see §§10.3, 21.1, 22.5)
- challenge the sale of the corporation in a merger where directors violated their duties to become informed or structure a transaction that was entirely fair (see §§12.3.3, 17.3)
- challenge corporate restrictions on share transferability (see §26.6)
- compel dissolution of the corporation, such as for deadlock or oppression of minority shareholders (see §27.2.1)
- challenge the denial or dilution of voting rights, such as when substantially all the corporation's assets are sold without shareholder approval (see §36.3)

As you notice, direct suits generally vindicate individual shareholders' structural, financial, liquidity, and voting rights. See *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996) (direct action when shareholder claimed directors abdicated statutory control to CEO under terms of employment agreement). Derivative suits, on the other hand, generally enforce fiduciary duties of directors, officers, or controlling shareholders—duties owed to the corporation. A suit claiming that fiduciary wrongdoing caused a loss in share value is usually derivative. For example, suits that ask directors to account for profits from a usurped corporate opportunity or that challenge executive

compensation as corporate waste are derivative suits.

Under the *Grimes* approach, courts make the direct-derivative distinction by focusing on who was injured and who will receive the relief. *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004) (characterizing a merger-delay claim as direct because delay of merger only harmed shareholders, not corporation, though dismissing direct claim on ground not yet ripe). In a direct suit, because damages are paid to shareholders and not the corporation, attorney fees are paid from the shareholders' recovery or in a class action from the common fund.

§18.2.2 Claims with Direct and Derivative Attributes

Some shareholder suits are difficult to characterize. For example, while most courts have characterized a suit to compel the payment of dividends as direct, some have characterized the suit as derivative. See *Cowin v. Bresler,* 741 F.2d 410 (D.C. Cir. 1984) (direct); *Gordon v. Elliman,* 119 N.E.2d 331 (N.Y. 1954) (derivative).

Sometimes, the facts suggest both a direct and a derivative claim. In such a case, the shareholder's pleading choice governs. For example, a wrongful refusal by management to provide a shareholders' list to a shareholder for a proxy fight may not only violate the shareholder's rights to inspection, but also management's duties of loyalty to the corporation. The shareholder may bring the claim as either a direct action to enforce inspection rights or as a derivative action to enjoin management's entrenchment, or both. See ALI Principles §7.01(c).

The shareholder's characterization of the suit, however, is not always controlling. A shareholder cannot escape the procedural restrictions of a derivative suit simply by claiming she was directly injured when the value of her shares fell as a result of a breach of a duty to the corporation. *Armstrong v. Frostie Co.,* 453 F.2d 914 (4th Cir. 1971).

But careful pleading can help. If a shareholder can characterize a transaction as diluting voting power, for example, even though the transaction may also be a fiduciary breach, the suit is direct. In *Eisenberg v. Flying Tiger Line, Inc.*, 451 F.2d 267 (2d Cir. 1971), a shareholder challenged a corporate reorganization in which shareholders of an operating company became, after a merger, shareholders of a holding company. The

corporation sought to require the plaintiff to post security for expenses, a derivative suit requirement (see §18.3.2 below). The court, however, held that the action was direct because the reorganization deprived the shareholder of "any voice in the affairs of their previously existing operating company."

§18.2.3 Close Corporation Exception

Lately many courts permit participants in a close corporation to sidestep the derivative suit procedures and bring direct actions to vindicate their corporate rights, including claims of fiduciary breaches. See *Crosby v. Beam,* 548 N.E.2d 217 (Ohio 1989). On the theory that close corporation participants owe duties to each other similar to those of partners in a partnership, close corporation shareholder or managers can sue each other directly. See ALI Principles §7.01(d). In a close corporation, compared to a public corporation, there is less risk of multiplicity of suits, preferential recovery, or strike suits brought to coerce a settlement.

One effect of the exception is that recovery in a close corporation suit is to individual shareholders or managers, not the corporation. Direct recovery may disadvantage the corporation's third-party creditors, whose interests in the corporation's financial viability are unprotected when a fiduciary breach leads to direct recovery only by shareholders or managers. The ALI Principles address this potential problem by giving the court discretion to treat an action raising derivative claims as a direct action if to do so "will not materially prejudice the interest of creditors of the corporation." ALI Principles §7.01(d).

Another effect of the exception is that the complaining shareholder or manager need not make a pre-suit demand on the board (requirement that shareholder in a derivative suit first seek to have the board vindicate the corporate interests, see §18.3.3 below). This reflects the futility of demand in a typical suit involving close corporation participants. For example, when a minority shareholder challenges the majority's oppression or exclusion, a demand on the majority-controlled board would accomplish little except to delay judicial resolution. See *Barth v. Barth*, 659 N.E.2d 559 (Ind. 1995) (noting that direct action prevents dismissal by special committee).

§18.2.4 Class Actions—Direct Suits Brought by

Representative

When a shareholder sues in his own capacity, as well as on behalf of other shareholders similarly situated, the suit is not a derivative action but a class action. In effect, all of the members of the class have banded together through a representative to bring their *individual direct actions* in one large direct action. Some of the most important suits enforcing fiduciary duties have been brought as direct class actions. See *Weinberger v. UOP, Inc.,* 457 A.2d 701 (Del. 1983) (class action challenging director actions and disclosure in squeeze-out merger); *Smith v. Van Gorkom,* 488 A.2d 858 (Del. 1985) (class action challenging director actions and disclosure in third-party merger).

Some procedural rules applicable to class actions—such as that the class action plaintiff be representative of the other shareholders' interests and that any settlement be approved by the court—also apply in derivative suits. See Fed. R. Civ. P. 23. They assure that shareholders are well represented and that the judicial process is not abused by nuisance plaintiffs.

A class action, however, does not interfere with the prerogatives of central corporate governance, and many requirements that apply to derivative suits do not apply to class actions. For example, in a class action the plaintiff need not make a demand on the board of directors before bringing suit (see §18.3.3 below). Class actions, however, have their own procedural hoops, such as that plaintiff-representatives bear the expense of providing notice to members of the class.

Examples

1. Ten years ago, Consolidated Engines acquired Digital Engineering in a merger. H. Russell Thoreau, Digital's principal shareholder, received 2 percent of Consolidated's common stock, and he was informally assured a seat on Consolidated's board for as long as he held the stock. Last year, Thoreau and Consolidated's chairman had a falling out. The board approved a repurchase of Thoreau's 10 million shares for $90 a share, at a time when the stock was trading on the NYSE at $80—a $100 million premium to Thoreau. Consolidated Engines' finances were seriously jeopardized by the purchase.
   a. Abe Pomerantz, a corporate attorney with broad experience representing shareholders, brought the repurchase to the attention of Pam Walden, a long-time shareholder of Consolidated. Under what

procedure can Walden seek to have the repurchase rescinded?

b. Walden (through her lawyer Pomerantz) sues to hold the directors liable for improvidently approving the repurchase of Thoreau's stock. Walden owns exactly $2,000 (.000004 percent) of Consolidated's stock. How much can she hope to recover?

c. Consolidated's directors offer to settle Walden's derivative suit by promising not to repurchase shares from other major shareholders without shareholder approval. The corporation, however, will recover nothing in cash. Can Pomerantz expect any fees?

2. Settlement negotiations fail and Walden's suit proceeds. Thoreau offers to repay 10 percent of the premium he received from Consolidated. The Consolidated board seizes the opportunity: It authorizes a suit against Thoreau, who then settles under the terms of his offer. The settlement is approved by the court.

   a. Can Walden continue her suit?

   b. Is there another course open to Walden?

   c. When Pomerantz hears of Consolidated's settlement, he is outraged. He has spent a significant amount of time preparing Walden's derivative suit for trial. Can Pomerantz seek attorney fees?

3. Consolidated's senior executives propose a management buyout (see §34.2). Under the terms of the buyout merger, Walden and all other shareholders would receive $80 for their shares.

   a. Walden thinks $80 is inadequate. The proxy materials seeking shareholder approval of the going-private transaction fail to disclose that Consolidated's board considered the company was worth at least $100 per share. Walden wants to enjoin the merger. What kind of suit would you advise?

   b. Walden brings both direct and derivative claims. The board agrees to settle by amending its proxy materials and paying Walden $500,000 on the condition that she dismiss all her claims. Are there any problems if Walden accepts?

   c. The shareholders approve the merger. Walden amends her complaint to claim damages. The court holds the directors liable for gross negligence in approving the merger at $80 per share. What is the appropriate remedy?

Explanations

1. a. Walden can model her suit to be derivative or direct:

   - **Derivative action.** Walden can sue on behalf of the corporation (derivative) alleging that Consolidated's directors breached their fiduciary duties to the corporation. The theory might be that the repurchase wasted corporate assets (see §12.3.2), lacked a reasonable relation to the threat of Thoreau launching a proxy fight or other takeover attempt (see §39.2.3), or constituted self-serving entrenchment (see §39.2.1). The suit would be subject to derivative suit requirements: demand on the board, possible shifting of fees, dismissal by the corporation.
   - **Direct action.** Walden might sue on her own behalf (direct) claiming the repurchases were an illegal distribution under an insolvency or balance sheet test (see §31.2). Otherwise, the transaction did not dilute Walden's voting rights (to the contrary, it concentrated them) or otherwise affect her financial or liquidity rights as a shareholder. Just because the corporation's assets are depleted, the indirect injury to Walden's interest does not allow her to sue in her own capacity.

   b. Nothing. This is a derivative suit because the allegation is that the directors violated their fiduciary duties to the corporation by approving the repurchase of Thoreau's stock and any recovery would go to the corporation. See *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004) (§18.2.1). Walden can only hope to increase the value of her shares to the extent corporate recovery increases general share value. There are a few exceptions to this approach. Shareholders can recover directly if the corporation is closely held or no longer in existence, or recovery would not redound to the benefit of contemporaneous shareholders indirectly injured. None of these, however, applies to Consolidated.

   c. Yes. Pomerantz can expect attorney fees either as part of the settlement or as ordered by the court in its approval of the settlement even though the corporation recovered nothing. Studies show that attorneys in settlement of shareholder suits involving public companies receive fees 90 percent of the time even though only 55 percent of the settlements involve monetary recovery.

   Under a lodestar method for computing his fees, Pomerantz's

billable hours would be multiplied by a reasonable hourly rate, which because of Pomerantz's stature would likely be at the upper end of the range. This amount then might be adjusted upward given Pomerantz's success in the face of the business judgment rule's teaching that courts normally defer to valuations by the board. The percentage-of-recovery method would not apply.

2. a. Probably not. Walden's derivative suit is brought on behalf of the corporation. If the corporation settles the subject matter of her claim, the corporate settlement is binding (res judicata) on Walden in her suit. The corporate suit resolves any corporate claims involving the Thoreau repurchase. Unless she can show fraud or a fiduciary breach that would justify vacating the judgment, she cannot continue her suit.

   b. A fiduciary challenge. Walden might be able to challenge the directors' decision to enter into the settlement as a breach of their duty of care or loyalty. This derivative claim may be difficult because of the business judgment rule. Unless Walden can show that the board was interested (because of an entrenchment motive) or failed to become informed about the settlement's terms, the board has discretion to make rational litigation decisions.

   c. Perhaps. Pomerantz might argue Walden's suit goaded the Consolidated board to act. In derivative litigation, shareholder-intervenors often recover their expenses and attorney fees if their efforts contributed to the recovery or settlement. Pomerantz could argue that Walden's suit brought the excessiveness of the repurchase price to the board's attention, and the board's out-of-court settlement (like a successful derivative suit settlement) should be seen as resulting from her suit and his efforts.

3. a. Walden can choose between a direct suit, a derivative suit, or a suit with both direct and derivative claims. She has a direct claim under the federal proxy rules and under the state "duty of disclosure" doctrine that the corporation failed to adequately disclose the terms of the merger. Rule 14a-9, Securities Exchange Act of 1934 (see §10.2); *Lynch v. Vickers Energy Corp.*, 429 A.2d 497 (Del. 1981) (see §10.3).

   Walden also has a derivative claim that the board's approval of this self-dealing, going-private merger and its deception about the merger price violate the executives' and the board's fiduciary duties (see

§13.3.3). Walden maximizes her leverage by bringing both claims in one suit. If she brings a federal proxy fraud claim, she must sue in federal district court, which has exclusive jurisdiction over these claims. She could bring her state fiduciary claims as pendent claims.

b. Yes. It is unclear why Consolidated is offering $500,000 to Walden. The payment does not seem to relate to her direct claim because the merger has not been approved and Walden has suffered no loss. Nor can the payment be tied to the derivative suit because any recovery in such a suit is to the corporation. Rather, the payment appears to be a bribe for her to dismiss the derivative claims. Although such a payment is perfectly acceptable in an individual direct action, it is not in a derivative suit. The court is unlikely to approve a settlement of the derivative claim in these circumstances (see §18.3.4 below).

c. Recovery by the shareholders, whether the claim is seen as derivative or direct. If the claim is direct, as was the case in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (see §12.3.4), the shareholder class members would recover in proportion to their shareholdings. The claim can be characterized as direct because the directors' approval of the merger led to the conversion of the shareholders' ownership interest to a cash payment right. To the extent the suit challenged the board's disclosure, it would also be direct. If the claim is seen as derivative, the normal rule is that defendant directors (or their insurers) would pay the corporation. In this case, this would result in payment to New Consolidated, the surviving corporation after the merger that acquired all the rights of Consolidated (see §36.2.1). But New Consolidated is controlled by new owners (the management team), and any corporate recovery would not remedy the injury to the body of shareholders who received an inadequate price for their shares. An exception to the rule of corporate recovery in derivative litigation is appropriate. Pro rata recovery by former Consolidated shareholders would produce a correct result.

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§18.3 PROCEDURAL RESTRICTIONS ON DERIVATIVE LITIGATION

The derivative suit is an essential tool to enforce management accountability. It is also subject to abuse. To address the risk that the derivative suit plaintiffs may not represent corporate interests, various procedural requirements seek to filter out abusive or spurious derivative litigation.

§18.3.1 Distorted Incentives in Derivative Litigation

Derivative litigation allows self-appointed shareholders to become champions of corporate rights. But the incentives of the derivative suit parties may produce results at odds with corporate interests:

- The plaintiff may be indifferent to the outcome of the litigation. Any recovery will be to the corporation, and the plaintiff's financial interest in the corporation will often be insignificant.
- The plaintiff's attorney, whose fees are usually contingent on a settlement or court award, may be indifferent to the substantive outcome —so long as there are attorney fees.
- The individual defendants (typically directors or officers of the corporation) usually will prefer settlement rather than trial. Settlement increases the chances their expenses, as well as amounts paid in settlement, will be indemnified by the corporation or covered by insurance (see §§15.1.2, 15.2.1).
- The corporation (the board of directors) often will be influenced by the interests of the individual defendants.

These realities of derivative litigation invite weak-willed and even evil-hearted plaintiffs. Some shareholders may be tempted to bring suit to coerce a settlement based on the suit's nuisance value—the infamous *strike suit.* The history of corporate law is spiced with colorful stories of "strike suit artists" with long and lucrative careers as gadfly plaintiffs. Derivative litigation also creates a potential for well-meaning but faint-hearted plaintiffs, unwilling to pursue a meritorious claim because of the incentives to settle.

Derivative litigation also threatens the integrity of the judicial process. By using the courts to bring vexatious litigation, strike suit plaintiffs waste and abuse judicial resources. Nonetheless, derivative litigation provides the

means for enforcing fiduciary duties, and corporate statutes attempt to distinguish between the meritorious claim and the strike suit.

§18.3.2 Litigation Procedural Requirements

A variety of procedural requirements in litigation attempt to weed out strike suits.

Plaintiff's Verification of Complaint

Some statutes require that the plaintiff verify the complaint. See Fed. R. Civ. P. 23.1. The requirement provides a basis for applying sanctions for perjury against those who fabricate charges in a strike suit. It is not necessary, however, that the plaintiff have personal knowledge or comprehend the specific factual allegation in the complaint so long as the plaintiff reasonably relied on her lawyer's investigation and advice. *Surowitz v. Hilton Hotels Corp.,* 383 U.S. 363 (1966).

Equity Shareholder Standing

Most statutes give equity (common and preferred) shareholders standing to bring a derivative suit to protect their residual ownership interests in the corporation against management abuse. Some cases have also allowed holders of stock options or convertible securities and creditors of an insolvent corporation to protect their ownership interests and assert derivative claims. The MBCA limits derivative suit standing to equity shareholders and beneficial owners and excludes option holders and convertible debtholders. MBCA §7.40(2). Some statutes, however, require that the plaintiff be a record (not merely beneficial) owner. See Del. GCL §327.

Dismissal of Multiple Suits

Often multiple shareholder-plaintiffs (and lawyers) will bring more than one derivative suit concerning the same transaction. If each suit makes essentially the same claims, allowing all to proceed would produce a wasteful and potentially confusing overlap. Courts will want to choose which shareholder should be the leading representative. Toward this end, courts have broad discretion to dismiss redundant derivative suits, to consolidate derivative suits brought in the same court, to stay proceedings in one suit to await a board investigation or the outcome in another suit, and to transfer

proceedings (in federal cases) to other courts. See ALI Principles §7.06 (stay pending board review or resolution of "related action").

Continuous and Continuing Ownership

Most statutes require the plaintiff to have been a shareholder when the alleged wrong occurred—the *contemporaneous ownership* requirement. MBCA §7.41(1); Del. GCL §327. The requirement is meant to assure that the shareholder did not buy shares to buy a lawsuit. The ALI Principles provide an exception to the requirement when an undisclosed wrong (such as a pattern of waste) was continuing when the plaintiff acquired her shares. See ALI Principles §7.02(a)(1).

A logical extension of the contemporaneous ownership rule is that the corporation itself cannot sue for wrongdoing that occurred before a change in ownership—the *vicarious incapacity* or *corporate incapacity* rule. If ownership changes, the corporation's new owners should not be able to cause the corporation to sue former managers (or shareholders) for wrongs committed before control changed hands. To allow the corporation to recover would produce a windfall for the new owners whose purchase price presumably took into account any losses caused by the earlier wrongs. See *Bangor Punta Operations, Inc. v. Bangor & Aroostook Railroad Co.,* 417 U.S. 703 (1974). The theory does not work as neatly when the recovery would benefit others besides the new owners—such as when the new owners hold less than 100 percent of the stock or when a corporate recovery would benefit creditors. Some jurisdictions, including Delaware, reject the vicarious incapacity rule and allow recovery by the surviving corporation. See *Lewis v. Anderson,* 477 A.2d 1040 (Del. 1983).

Another exception to the contemporaneous ownership rule arises when shareholders of a parent corporation complain about wrongdoing in a subsidiary. See *Brown v. Tenney,* 532 N.W.2d 230 (Ill. 1988) (finding "double derivative action" to be a longstanding doctrine of equity jurisprudence). In effect, a double derivative action permits the parent shareholders to claim that the parent has failed to take action against corporate wrongs occurring in the subsidiary.

In addition to the contemporaneous ownership rule, some statutes require that the plaintiff continue to be a shareholder when suit is brought and then through trial—the *continuing interest* requirement. Cf. MBCA §7.41 (no continuing ownership requirement, but plaintiff must "fairly and adequately"

represent corporate interests). The continuing interest requirement tests the genuineness of the plaintiff's intentions. Delaware courts recognize a narrow exception when the plaintiff ceases to be a shareholder after a fraudulent or illegal merger. *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1983). The ALI Principles broaden the exception to allow a plaintiff to continue her derivative action after a merger if the action was pending at the time of the merger or if the plaintiff is best able to vindicate the shareholders' interests. ALI Principles §7.02(a)(2).

Shifting Expenses to Plaintiff

Many statutes provide for shifting the defendants' litigation expenses, including attorney fees, to the plaintiff. This discourages unfounded derivative claims and compensates defendants who must defend strike suits. Under the MBCA, the court may order fee-shifting if the plaintiff commenced or maintained the suit "without reasonable cause or for an improper purpose." MBCA §7.46(2). This standard forces derivative suit plaintiffs to tread cautiously; the normal standard for recouping expenses based on a claim of frivolous prosecution is more demanding and requires a showing of malicious intent or fraud. Cf. MBCA §13.31 (in appraisal proceeding, expenses may be shifted to shareholder-dissenter who acted "arbitrarily, vexatiously, or not in good faith").

A once-common requirement in many states—though now very few—allowed the court to require the plaintiff to post security (pay a bond) for the defendants' litigation expenses as a condition of maintaining the action. The court would act on a motion of the corporation or the defendants. A security-for-expense requirement often had a lethal effect on derivative litigation. The cost of posting security and the risk of having to pay the amount that the bond secured usually outweighed any gain a shareholder-plaintiff might hope for in the suit. Most modern statutes reject this requirement as going too far in limiting fiduciary accountability. See ALI Principles §7.04(c).

Many of the security-for-expense statutes exempted shareholders with a specified percentage of ownership (such as 3 percent or 5 percent) or a minimum dollar amount ($25,000 or $50,000). The exemptions assumed that most strike suits are brought by shareholders with small holdings and presumably little real concern for the corporation's interests. Shareholder-plaintiffs would try to avoid the security-for-expense requirement by bringing direct actions (see §18.2) or actions under federal law, such as Rule 10b-5

(see §9.1).

Recently, as shareholder litigation has become a fixture of mergers and acquisitions practice, some corporations have experimented with putting fee-shifting provisions in the corporate bylaws. The purpose has been to discourage groundless shareholder claims, particularly in M&A transactions involving public corporations (where more than 90 percent of such transactions are challenged, often by multiple shareholders). See §39.2.3. Are such bylaws valid, when unilaterally created by corporate boards without shareholder approval? In 2014, the Delaware Supreme Court addressed the enforceability of a board-passed, fee-shifting bylaw. *ATP Tour, Inc. v. Deutscher Tennis Bund (German Tennis Federation)*, 91 A.3d 554 (Del. 2014) (en banc). The case, brought by a member of the Association of Tennis Professionals Tour, challenged a bylaw amendment adopted by the corporation's board that provided any member that brought an intracorporate claim and failed to obtain "a judgment on the merits that substantially achieves the remedy sought" could be compelled to reimburse the ATP Tour for its defense costs.

The court ruled that the ATP bylaw was facially valid, given that it dealt with an intracorporate matter—a proper subject for the bylaws. The court explained, however, that a facially-valid bylaw might be invalid if it had an improper purpose, though the court pointed out that deterring litigation was not an improper purpose. The court said that corporations could create a fee-shifting bylaw "midstream" even against members who had joined the corporation before the bylaw's adoption.

The *ATP* decision—though involving a not-for-profit, non-stock corporation—has potentially far-reaching implications for for-profit corporations. If used by corporate boards to discourage—if not squelch—shareholder litigation in M&A transactions, it could lead to a number of results. First, shareholders by shareholders could bring such litigation as "packaged settlements" in which management would be asked to enter into a settlement agreement without actual litigation. Shareholder activists could propose their own bylaw amendments to either rescind or prevent board-passed, fee-shifting bylaws. See §7.1.4. Shareholder activists could initiate retaliatory "just say no" votes against directors who had approved such bylaws. And, as has happened in Delaware, state legislative proposals could preclude boards from unilaterally creating fee-shifting bylaws. Time will tell.

§18.3.3 Demand Requirement—Exhaustion of Internal Remedies

Many statutes require that the derivative plaintiff's complaint state with particularity her efforts to make a demand on the board to resolve the dispute or the reasons she did not make demand. Del. Ch. Ct. R. 23.1; Fed. R. Civ. P. 23.1. By their terms, these statutes neither require the plaintiff to make a pre-suit demand on the board nor specify the effect that should be given the board's response. Nonetheless, many courts (including Delaware) have interpreted the statutes to make demand mandatory unless demand would be futile (see §18.5.3). The demand-pleading requirement allows the court to ascertain whether the board could have acted on the demand. *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984).

A demand requirement has some advantages. It serves as a kind of alternative dispute mechanism that requires a challenging shareholder to first exhaust intracorporate remedies. If litigation is beneficial, it allows the corporation to control the proceedings.

But demand has a number of untoward effects. A pre-suit demand forewarns defendants of an impending suit, giving them an opportunity to take evasive actions. It delays litigation while the shareholder waits for the board to act on her demand. Making demand might be understood as the challenger's concession that the board is capable of addressing the problem. And if the shareholder brings suit without making demand, the court must resolve whether demand was excused—litigation within litigation.

Many recent statutes explicitly impose a demand requirement in all cases, thus forcing a shareholder contemplating a derivative suit to first make a demand on the board. Under the MBCA, the shareholder must wait for 90 days before filing suit unless the board rejects the demand or the corporation would be irreparably injured by waiting. MBCA §7.42. The demand requirement gives the board (even if the directors would be named defendants) a chance to take corrective action and avoids the difficult question whether demand is excused. See also ALI Principles §7.03(b) (recommending a universal demand requirement unless it would irreparably injure the corporation).

These different approaches do not answer what substantive effect should be given to the board's rejection of a demand or its refusal to bring a suit. Also unanswered is whether the board (or a committee of the board) can act

on behalf of the corporation to dismiss the litigation. The demand-pleading requirement is inextricably linked to the question of who can decide the fate of derivative litigation. We discuss these issues and the dismissal of derivative litigation below. See §18.5.

§18.3.4 Court Approval of Settlement— A Clean Solution

The principal danger of derivative litigation is the potential for abusive settlements. Unlike normal litigation in which an arm's-length compromise agreed to by plaintiff and defendant provides the best measure of the suit's worth, derivative litigation provides no such assurance. In a derivative suit *none of the parties* may represent the interests of the corporation on whose behalf suit is presumably brought.

Most statutes face this problem and require judicial approval before a derivative suit can be settled, discontinued, or dismissed. MBCA §7.45; Fed. R. Civ. P. 23.1. Proponents of the settlement have the burden to show it is fair and reasonable to the corporation. To decide whether to approve the settlement, the court has broad discretion to consider

- the terms of the settlement, including recovery by the corporation (or other relief) and any reimbursement of expenses (including attorney fees) to the shareholder-plaintiff and to the individual defendants
- the outcome that might have resulted from a trial, discounted by the inherent uncertainty of litigation, the costs caused by the delay of trial, additional litigation expenses that the corporation might be required to pay the plaintiff, additional indemnification payments to the defendants if they are successful or if indemnification is determined to be appropriate, disruption of business and possible negative publicity because of trial, and increased insurance premiums if recovery at trial is higher than in settlement

Because the proponents' reasons for supporting the settlement may diverge from general corporate and shareholder interests, many statutes require the court to notify nonparty shareholders and solicit their comments. MBCA §7.45; Fed. R. Civ. P. 23.1. In a public corporation, where such a

notice-and-comment procedure would be tantamount to an expensive proxy solicitation, the court may request comments from a sampling of shareholders or solicit comments through published notice.

By their terms, these settlement procedures apply only to derivative litigation. An argument can be made, however, that they should apply whenever the corporation on its own (without a lawsuit being filed) settles claims out of court that might have been brought in a derivative suit. Such an out-of-court settlement by the corporation raises doubts about the parties' incentives much as an in-court settlement does. In *Wolf v. Barkes,* 348 F.2d 994 (2d Cir. 1965), the Second Circuit rejected this argument even though the corporation's out-of-court settlement purported to resolve fiduciary claims involving management stock options pending in a derivative suit. Judge Friendly explained that management flexibility should not be impeded in settling corporate claims and that the out-of-court settlement would not necessarily preclude the shareholder's continuing her derivative claims. The shareholder could still attack the settlement as unfair self-dealing, fraudulent, or wasteful. But under this analysis, a corporation's out-of-court settlement is subject to less stringent review than when the same claims are settled as part of a derivative suit.

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§18.4 DERIVATIVE LITIGATION IN FEDERAL COURTS

§18.4.1 Diversity Jurisdiction

In federal diversity action, there are two principal issues: (1) Is the corporation a plaintiff or a defendant for assessing the parties' diversity of citizenship? (2) What procedural rules govern the action—state or federal?

Corporation Is a Defendant

The Supreme Court has held that even though shareholders technically bring derivative suits on behalf of the corporation, the corporation should be treated as a defendant for purposes of federal diversity jurisdiction if it (or, more precisely, its management) is antagonistic to the claim. *Smith v. Sperling,* 354 U.S. 91 (1957). (Recall from Civil Procedure that a corporation is considered

both a citizen of its state of incorporation and its principal place of business. See 28 U.S.C. § 1332(c)(1).)

A further requirement under Fed. R. Civ. P. 23.1 is that the suit not be brought collusively to avoid "complete diversity" requirements. For example, if a North Carolina corporation wished to sue a North Carolina supplier for breach of contract (no diversity of citizenship), a Virginia shareholder of the corporation could not collude with management to bring a derivative action on behalf of the corporation based on diversity by naming the corporation as nominal defendant and the North Carolina supplier as real defendant.

State Derivative Suit Requirements Are "Substantive"

Courts have held that certain state procedural requirements (those that relate to the allocation of power between shareholders and management) are "substantive" under the *Erie* doctrine. This means that, even though not imposed by federal Rule 23.1, some state conditions such as the security-for-expense requirement apply in derivative actions brought under federal diversity jurisdiction actions. *Cohen v. Beneficial Industrial Loan Corp.,* 337 U.S. 541 (1949).

§18.4.2 Federal Actions

Actions brought in federal court on behalf of the corporation claiming violations of federal law are subject to federal, not state, procedures. The Supreme Court has held that derivative suits may be brought for alleged violations of Rule 10b-5 (the general securities trading antifraud rule) and Rule 14a-9 (the proxy antifraud rule) of the Securities Exchange Act of 1934 if the fraud was perpetrated on the corporation. *Superintendent of Insurance v. Bankers Life & Casualty Co.,* 404 U.S. 6 (1971) (Rule 10b-5); *J. I. Case Co. v. Borak,* 377 U.S. 426 (1964) (Rule 14a-9). In such derivative cases, the procedural requirements of Rule 23.1 apply, but state procedural requirements—such as state security-for-expense requirements—do not.

Even in a derivative suit brought under federal diversity jurisdiction, which generally adopts the substantive law of the state in which the federal court sits, federal procedural rules apply, such as the continuous ownership requirement of federal Rule 23.1. *Kona Enters. v. Estate of Bishop,* 179 F.3d 767 (9th Cir. 1999).

Nonetheless, the Supreme Court has said that when there are gaps in

federal substantive law on the question of allocation of power in the corporation, federal law should refer to the law of the state of incorporation. *Kamen v. Kemper Financial Services, Inc.,* 500 U.S. 90 (1991). Thus, in a derivative suit brought under the federal Investment Company Act for the breach of fiduciary duties by a mutual fund's investment advisor, the Court held that demand on the board was to be determined by reference to state law, absent contrary federal policies. This is because the demand requirement serves to allocate corporate governance between the board and shareholders —traditionally a matter of state law. The Court rejected the lower court's conclusion that a universal demand requirement makes good policy sense and should be adopted as a matter of federal common law.

Examples

1. Protox Corporation, a public company incorporated in Delaware, issues options on 400,000 shares of its common stock to Paula, the outgoing CEO and chair of the board. The options entitle Paula to buy Protox shares at $30 (the current market price) at any time for the next five years.
   a. Lois, a longtime Protox shareholder, is outraged. She brings a derivative suit in federal district court in the State of New Columbia, claiming that the directors breached their fiduciary duties. Delaware does not have a security-for-expense requirement, but New Columbia does. Is Lois subject to New Columbia's procedures?
   b. Believing the security-for-expense requirement applies, Lois looks for other shareholders to join her so their aggregate shareholdings will exceed the New Columbia threshold of $50,000. Lois finds three such shareholders, but none owned their shares when the board granted Paula's stock options. New Columbia does not have a contemporaneous ownership requirement. Can Lois bring her federal diversity action?
   c. Is there any way for Lois to avoid this tangle of derivative suit requirements?
2. After discovery, Paula agrees to settle Lois's claims and to return half the stock options granted her.
   a. Lois's complaint had sought a return of all the options. Can the court approve the settlement?

b. Under the terms of the settlement, the corporation agrees to pay Lois's attorney $500,000 for his representation. Is the court bound by the parties' agreement on attorney fees?

3. While the federal court in New Columbia is reviewing the settlement, shareholders file two more derivative actions challenging the stock options, one in state court in Virginia and the other in federal district court in California.
   a. What becomes of these later actions?
   b. What will be the effect on them of a court-approved settlement of Lois's claim?
   c. The plaintiff in the Virginia case filed his suit hoping that a successful resolution of the New Columbia suit would automatically allow him to claim attorney fees in his suit. Will this scheme work?
4. Protox has become the subject of takeover speculation, and the board approves contracts for top executives that promise three years' worth of compensation if forced to leave the company after a change in ownership (commonly known as "golden parachutes"). One year later, Protox is bought in a leveraged buyout by RKK Partners, which after a cash-out reverse subsidiary merger (see §36.2.3) becomes Protox's 100 percent parent.
   a. The new Protox board fires many Protox executives, but RKK chafes at paying their golden parachutes. Can RKK bring a derivative suit on behalf of new Protox challenging the contracts?
   b. RKK has the new Protox board initiate a suit against the old directors for awarding the golden parachutes. Can Protox assert these fiduciary claims?
   c. Lois, who owned Protox shares when the board approved the golden parachutes, believes RKK paid less because of the contingent golden parachute liability. Can she bring a derivative suit challenging the golden parachutes?

Explanations

1. a. Perhaps not. Lois's action in New Columbia federal court is based on diversity jurisdiction. *Erie* requires that the district court apply the substantive rules of New Columbia, including its choice-of-law rules. In a case involving substantially the same facts, the Supreme Court has

held that a security-for-expense requirement is substantive and must be applied in diversity actions. *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541 (1949).

Although this analysis would seem to require the court to impose New Columbia's security-for-expense requirement, closer analysis leads to the opposite conclusion. Remember the security-for-expense requirement (like other derivative suit requirements) has dual purposes, to protect corporate interests and prevent abuse of the judicial process. In this case, New Columbia has no reason to be concerned about either. Protox is a Delaware corporation, and to the extent the security-for-expense requirement assures that corporate interests are well represented in derivative litigation, this is a concern of Delaware corporate law, which does not impose such a requirement on its shareholder-litigants. Moreover, suit is brought in federal court, and to the extent the security-for-expense requirement protects courts from abuse of their process, that is a concern of the federal district court, whose rules (specifically Rule 23.1) do not impose a security-for-expense requirement. *Cohen* may have been wrongly decided.

b. No. The three new shareholders, although their combined holdings exempt the plaintiffs from the security-for-expense requirement, are not contemporaneous owners. Rule 23.1 protects against abuse of judicial process in federal derivative suits and imposes this procedural requirement even though the state of incorporation, New Columbia, does not. Thus, Lois avoids the New Columbia obstacle but is now caught by the federal obstacle—a patchwork of federal and state rules.

Also notice that in this diversity suit the plaintiff-shareholders must be from states completely different from that of the corporation (nominal defendant) and those of the other defendants (Paula and any named directors). The suit must also seek more than $75,000 in damages *to the corporation*, an amount unrelated to the shareholdings of the plaintiff-shareholders.

c. Perhaps, though she needs more facts. Lois can avoid the security-for-expense requirement by bringing a direct action against the corporation under state law. Direct claims are not subject to derivative suit procedural requirements (see §18.2 above). For example, she could make a direct claim if the options were not properly authorized or if

they required shareholder approval.

In addition, Lois can avoid state derivative suit requirements by bringing a federal securities claim—whether direct or derivative. For example, she might bring a federal derivative suit claiming that Paula had violated her Rule 10b-5 duties of full disclosure to the corporation if she failed to disclose the options were without consideration (see §22.3).

2. a. Yes, if the court determines the settlement is fair and reasonable to the corporation. In making this determination, the court will weigh the terms of the settlement against the probable outcome of the case had it gone to trial, offset by the delay, expense, and inherent uncertainty of a trial, particularly when the board's grant may be protected by the business judgment rule.

   b. No. Again the issue is whether this aspect of the settlement is "fair and reasonable." Whether the attorney fees are related to the outcome and represent a fair valuation of services is largely within the discretion of the court.

3. a. It depends on how the courts exercise their procedural discretion. Because derivative suit plaintiffs sue on behalf of the corporation, subsequent derivative suits may be dismissed, consolidated with the original suit, transferred to another court, or stayed pending the outcome of the original suit. Although the Virginia state court cannot consolidate or transfer the new case, it can dismiss or stay it. The federal court in California can dismiss or stay the case, or transfer it to the federal court in New Columbia for that court to decide its disposition.

   b. The settlement would have a res judicata effect and bar the continuation of any other suit based on the same claims, provided the settlement satisfied due process (see §18.1.5). An important question would be whether the settlement advanced corporate or shareholder interests or merely benefited Lois's lawyers.

   c. No. Many statutes permit the court to shift fees against derivative suit plaintiffs. Even if the New Columbia suit succeeds, the defendants in the Virginia suit could argue that the "me too" plaintiff brought it for an "improper purpose." See MBCA §7.46(2). Fee-shifting deters suits brought for their nuisance value.

4. a. Perhaps not. If RKK was not a shareholder when the directors awarded

the golden parachutes, the contemporaneous ownership requirement would bar RKK from pursuing a derivative claim. Although RKK might argue the payments constitute a "continuing wrong" to the corporation, RKK in all likelihood discounted its purchase price to account for the contingent golden parachute obligations. If so, any recovery by RKK would be a windfall.

Even if RKK owned some shares before the buyout and was a contemporaneous owner, a court might apply the same theory to deny a recovery to RKK or might decide the recovery should be shared pro rata with other pre-buyout shareholders. See ALI Principles §7.01(d) (applying this analysis in context of closely held corporation). It would be an important factual question whether RKK figured its potential golden parachute obligations in its buyout price.

b. Perhaps not. Protox may be barred by the vicarious incapacity rule from bringing a suit that RKK, its only shareholder, could not bring derivatively. (See the previous answer.) Any recovery by Protox would produce a windfall for RKK if it had already discounted Protox's value to take into account the contingent golden parachute obligations. Nonetheless, some jurisdictions allow the surviving corporation (at the behest of new owners) to pursue existing fiduciary claims, and this contingent benefit is sometimes taken into account in deciding the purchase price.

c. Perhaps, depending on the jurisdiction. If the jurisdiction does not have a continuing interest requirement, a former shareholder who was a contemporaneous owner would have standing if she fairly and adequately represented the corporation—or, here, all former shareholders after the merger. MBCA §7.41.

If the jurisdiction has a continuing interest requirement, Lois could argue an exception to the requirement. Unless cashed-out shareholders could sue the former directors for premerger wrongdoing, their overreaching would go undeterred and the shareholders' loss uncompensated. See ALI Principles §7.02(a)(2) (allowing former shareholder to bring a postmerger derivative suit seeking pro rata recovery). The only question is whether Lois is best suited to represent the other former shareholders.

Under Delaware's strict "continuing interest" rule, Lois could not

maintain a derivative suit after the cash-out merger. At most, she could bring a direct action if the merger was illegal or accomplished by fraud. See *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1983). The strict Delaware approach assumes the buyer has paid the former shareholders for the right to sue for management abuse. If RKK chooses not to pursue this claim, the claim would be lost.

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§18.5 DISMISSAL OF DERIVATIVE LITIGATION— FINDING A COPORATE VOICE

In theory, a shareholder's derivative suit is brought on behalf of the corporation, and the "corporation" should have a voice in deciding whether the suit is brought, maintained, or settled. But who speaks for the corporation:

- the individual shareholder-plaintiff?
- the shareholders as a group?
- the board of directors?
- a committee of the board?
- the court?

As you review the variety of approaches to identifying a trustworthy corporate voice, consider the incentives of each speaker.

§18.5.1 Self-Appointed Derivative Suit Plaintiff

A derivative suit plaintiff, though purporting to step into the corporation's shoes and to represent general corporate interests, may in fact be representing his own inconsistent interests. To prevent abuse of the judicial process and protect the integrity of centralized corporate governance, derivative suit plaintiffs are subject to a variety of procedural rules (see §18.3 above). In addition, corporate law increasingly instructs judges to listen to other voices in deciding the fate of a shareholder's derivative suit.

§18.5.2 Unwieldy Body of Shareholders

In theory, allowing the body of shareholders to decide the fate of derivative litigation would overcome the problems of entrusting fiduciary litigation to individual shareholder-plaintiffs. But requiring a demand on all shareholders and permitting a shareholder majority to decide whether the suit should proceed would create its own problems:

- **Proxy contest.** In public corporations, a demand requirement would entail the shareholder-plaintiff initiating an expensive and burdensome proxy contest before suit could commence. It would effectively kill derivative litigation against all but the clearest and most costly fiduciary breaches.
- **Shareholder passivity.** Shareholders, particularly in a public corporation, might lack the incentives to evaluate the relative costs and benefits of derivative litigation. Shareholders might approve suits that are not in the corporation's best interests and disapprove others that are.
- **Illegitimate.** Allowing a shareholder majority to refuse to litigate would permit ratification of fraud, self-dealing, or waste. In a public corporation, management's control of the proxy machinery might make majority refusal of doubtful legitimacy. In a close corporation, majority refusal would predictably gut fiduciary protection for the minority.

Most statutes do not require a demand on shareholders. MBCA §7.42; ALI Principles §7.03(c); cf. Fed. R. Civ. P. 23.1 (pleading requirement). Moreover, in those states where shareholder demand is required, courts have excused it when the derivative plaintiff alleges a wrong (such as waste) that cannot be ratified by a majority of shareholders or when demand would be burdensome because of the number of shareholders. See *Mayer v. Adams*, 141 A.2d 458 (Del. 1958).

§18.5.3 Board of Directors—Voice of Centralized Corporate Governance

The board's power to speak for the corporation in a derivative suit is linked to whether shareholders must make a demand on the board.

Dilemma

Before we consider the various judicial and statutory approaches, consider the mixed signals from corporate law. On the one hand, the business judgment rule assumes the board has wide discretion to make business decisions, including litigation decisions. The directors, more than shareholders or judges, are better positioned to evaluate whether a claim has merit, whether it is consistent with corporate interests, and whether corporate resources (money and personnel) should be used to pursue it. If there is no conflict of interest, the board's incentives will predictably be closely aligned with general corporate interests.

On the other hand, if the claim involves charges of a fiduciary breach, corporate law doubts the board's impartiality. Even directors not involved in the alleged wrongdoing or not themselves named defendants may be solicitous of fellow directors (or other members of the control group) who are sued. *Structural bias* on the board because of personal, professional, and social ties may create pressures for directors to act in ways inconsistent with general corporate interests.

Despite this tension between board discretion and answerability, courts and statutes increasingly assume that disinterested directors may be a better voice for the corporation than self-appointed shareholder-plaintiffs.

Demand-Required (Futility Exception)

Under the prevailing *judicial* approach—the one applicable in Delaware—the board of directors can decide the fate of derivative litigation if a pre-suit demand on the board is required. If the board receives a demand and refuses to act or settle the charges, its response (or nonresponse) receives deferential review under the business judgment rule. A shareholder-plaintiff must show the board's response to the demand was self-interested, dishonest, illegal, or insufficiently informed. Usually a demand-required claim is a lost claim.

But demand is excused if it would be futile to bring the matter to the board. When demand is excused, the directors cannot block a derivative suit. Their voice is silenced. The assumption in a demand-excused case is that the board is unlikely to be objective in considering the merits of the suit. Allowing a tainted board to make litigation decisions would be tantamount to allowing an accused to decide whether to prosecute himself.

The demand-excused approach produces the following results:

Demand on Board	
Demand required	Board decides fate of claim, subject to review under business judgment rule
Demand excused	Claim goes forward; board cannot dismiss

When is demand excused? The Delaware Supreme Court has adopted two tests for demand futility. *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984). Demand is excused if the shareholder-plaintiff can allege *with particularity facts that create a reasonable doubt* on either of two scores—

- doubt that a majority of the current directors on whom demand would have been made are disinterested and independent, or
- doubt that the challenged transaction was protected by the business judgment rule—by showing a conflict of interest, bad faith, grossly uninformed decision-making, or a significant failure of oversight.

To make this showing, the plaintiff must point to specific facts (before discovery) that tend to show *either* that the board is now untrustworthy to respond to the demand *or* that the underlying transaction was improper. (The *Aronson* decision states the trial court is to make both inquiries—a seeming conjunctive standard—but later cases make clear either showing is sufficient to establish demand futility.) See *Marx v. Akers,* 666 N.E.2d 1034 (N.Y. 1996) (adopting *Aronson* approach and excusing demand when (1) current board is "interested" in challenged transaction, or (2) board decision not appropriately informed, or (3) challenged transaction so egregious that it could not be product of sound business judgment).

As applied, the *Aronson* test places a heavy burden on derivative plaintiffs seeking review of board operational decisions. See *Brehm v. Eisner,* 746 A.2d 244 (Del. 2000) (refusing to excuse demand despite findings of "lavish" pay and "sloppy" review by board of directors) (see §14.2.4). In *Aronson,* for example, the plaintiff challenged a compensation package the board approved for the company's retiring chair and 47 percent shareholder. The court said that just because the defendant owned a controlling block of the company's stock and had selected all of the directors did not create a "reasonable doubt" concerning the directors' independence. Further, the court held the alleged facts failed to make out a claim of waste, even though the allegations included that the defendant performed "little or no service" and

would be compensated whether or not he was able to perform.

What if a shareholder brings a derivative suit, but does not yet have particularized facts, to show that demand should be excused? Can the shareholder, before the hearing to dismiss, make a "books and records" inspection request? In Delaware, the answer is yes. The Delaware Supreme Court has said that a shareholder can begin an action under Del. GCL §220 to obtain corporate documents after filing the derivative suit, though it is "preferable" to file the §220 action before bringing the derivative suit. See *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140 (Del. 2011) (reiterating that "proper purpose" under §220 includes obtaining facts to plead demand futility in derivative suit, see §7.1.4).

In Delaware, making a demand on the board, rather than bringing a derivative action and pleading demand futility, generally precludes later bringing the derivative suit. Once a shareholder makes a demand, she cannot bring a derivative suit unless she can show the board's rejection of the demand was wrongful—that is, it was not made in good faith after a reasonable investigation. *Spiegel v. Buntrock*, 571 A.2d 767 (Del. 1990). A shareholder who makes a demand cannot later assert that demand should have been excused. *Levine v. Smith*, 591 A.2d 194 (Del. 1991). Thus, making a demand in Delaware effectively places the fate of the derivative claim in the hands of the board.

Universal Demand

The MBCA avoids the demand-required/demand-excused question (thus avoiding litigation within litigation) by making demand a universal precondition to derivative litigation. MBCA §7.42. A shareholder wishing to file suit must make a demand and then wait 90 days—unless the board rejects the demand or waiting would result in irreparable injury to the corporation. See also ALI Principles §7.03 (requiring demand in every case, except when "irreparable injury" would result).

After the 90-day waiting period, the shareholder may bring a derivative suit. If the board rejected the demand, the plaintiff must plead with particularity that either the board's rejection of the demand was not disinterested or the rejection was not in good faith or not informed. (This is similar to the Delaware *Aronson* approach.) After suit is brought, the board can move for dismissal if independent directors constitute a quorum (a majority of the board) and a majority of independent directors determine in

"good faith" and after a "reasonable inquiry" that maintaining the suit is not in the corporation's best interests. MBCA §7.44(a), (b)(1). The statute defines independence much as have the courts. A director is not disqualified merely because he is named as a defendant, was nominated or elected to the board by defendants, or approved the challenged transaction. MBCA §7.44(c).

Demand and Dismissal in Federal Court

If a derivative claim is brought under federal law, the demand and dismissal rules are governed by the law of the incorporating state unless its application would be inconsistent with federal policy. *Burks v. Lasker,* 441 U.S. 471 (1984). The Supreme Court has rejected a federal universal demand standard in federal securities derivative litigation because the demand requirement bears on the allocation of power in the corporation, a matter federal law normally leaves to the law of the state of incorporation. *Kamen v. Kemper Financial Services, Inc.,* 500 U.S. 90 (1991).

State rules governing shareholder litigation, however, must also be consistent with federal policy. In *Daily Income Fund, Inc. v. Fox,* 464 U.S. 523 (1984), the Supreme Court concluded no pre-suit demand is required in a shareholder suit against a mutual fund's investment advisor under §36(b) of the Investment Company Act of 1940. The Court characterized the suit as not derivative, thus making Fed. R. Civ. P. 23.1 inapplicable. The Court pointed out that §36(b) is a remedial provision that allows mutual fund investors to challenge unfair compensation in investment advisory contracts, which are rife with conflicts of interest.

§18.5.4 Special Litigation Committee

During the 1970s, boards of directors responded to a spate of derivative litigation with an ingenious device. The board, whose members were usually named as defendants for various infractions, appointed a special litigation committee (SLC) of disinterested and often recently appointed directors with the exclusive power to decide whether the suit should go forward. The committee, often assisted by outside counsel, investigated the charges and prepared a (usually voluminous) report. The committee invariably recommended that the suit not be pursued further and then sought its dismissal.

During the 1980s, SLCs gained popularity. Typically, the board would give the committee full power to make litigation decisions for the corporation. See §30.1.3. The committee usually was comprised of directors who had not participated in the challenged transaction and hence could not be named as defendants. SLCs have shown a remarkable disposition for director defendants. In the vast majority of cases, SLCs refuse to continue the suit against a colleague.

Academic commentators doubted the trustworthiness of the SLC ruse and pointed to research on group dynamics suggesting committee members face unspoken pressure to dismiss charges against fellow directors—so-called structural bias. See *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985) (holding committee member not to be independent because he was director when the challenged actions took place, was named as defendant, had political and financial dealings with company's dominating CEO, and was president of university that had received significant contributions from the CEO and company).

Courts have responded to SLCs in a variety of ways.

Business Judgment Review

The first cases during the 1970s uniformly held that an SLC's recommendation to dismiss litigation was like any other corporate business decision, despite the self-interested taint of the board that had appointed the committee. Unless the plaintiff could show the committee's members were themselves interested or had not acted on an informed basis, the committee's recommendations were entitled to full judicial deference under the business judgment doctrine. *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976); *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979).

Under this approach, after a committee investigates the claims made by the plaintiff, it can recommend dismissal of the litigation on many grounds: The suit would undermine employee morale and waste employee time; litigation expenses would exceed any possible gain; the suit would create bad publicity for the company; the underlying claim lacks merit; the corporation might be required to indemnify a successful defendant; and so on. Some commentators criticized this business judgment deference as sounding the death knell for derivative litigation, and the approach has eroded. See *In re PSE&G Shareholder Litigation*, 801 A.2d 295 (N.J. 2002) (applying modified business judgment rule to require corporation to show SLC's

independence, good faith, and reasonable decision).

Heightened Scrutiny (Demand-Excused Cases)

In Delaware, when demand on the board is excused as futile, the courts listen to the SLC—but with suspicion. In *Zapata Corp. v. Maldonado,* 430 A.2d 779 (Del. 1981), the Delaware Supreme Court agreed there might be "subconscious abuse" by members of the committee asked to pass judgment on fellow directors. The court established a two-part inquiry into whether an SLC's recommendation to dismiss would be respected:

- **Procedural inquiry.** The defendants must carry the burden of showing the committee members' independence from the defendants, their good faith, reasonable investigation, and the legal and factual bases for the committee's conclusions. If there is a genuine issue of material fact as to any of these counts, the derivative litigation proceeds. See *In re Oracle Corp. Derivative Litigation,* 824 A.2d 917 (Del. Ch. 2003) (finding lack of SLC independence, despite being composed of unnamed board members and its use of reputable outside law firm, because SLC members had long-standing professional and academic relationships with principal defendants through Stanford University).
- **Substantive inquiry.** Even if the SLC's recommendation passes this first stage of inquiry, the trial judge may apply his own "independent business judgment" as to whether the suit should be dismissed. This second inquiry—which focuses on such matters as the strength of the fiduciary claims and the likelihood of recovery—is far more intrusive than even the fairness test applicable to self-dealing transactions. It recognizes that judges are particularly adept (in fact it is generally their job) to evaluate the merits of litigation and that judicial incentives to further the interests of the corporation are perhaps stronger than those of an SLC.

At first blush, the two-step *Zapata* inquiry seems to be a remarkable departure from cases that apply the business judgment presumption to SLC recommendations. But in Delaware, the *Zapata* test applies to SLC recommendations only in demand-excused cases. Three years after *Zapata*, the Delaware Supreme Court significantly limited the decision's importance

by making demand a requirement in a large number of cases. *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984) (see §18.5.3 above).

Heightened Scrutiny (Regardless of Demand)

Some courts have subjected SLC dismissal recommendations to heightened scrutiny whether demand is required or excused. Under this approach, the trial court independently evaluates the suit's merits, giving some (but not presumptive) weight to the SLC's recommendation. *Joy v. North,* 692 F.2d 880 (2d Cir. 1982); see also ALI Principles §7.08.

For example, in *Alford v. Shaw,* 358 S.E.2d 323 (N.C. 1987), the North Carolina Supreme Court focused on the court's supervisory function in derivative litigation under the state's demand-pleading statute. See §18.3.3. The court refused to read the statutory requirement that the plaintiff plead his demand efforts as requiring different levels of judicial scrutiny depending on whether demand was required or excused. Just as settlement of derivative litigation is subject to court review, so is dismissal. Under the statute, the court concluded, the trial judge could not disregard shareholder interests by relying blindly on the SLC's recommendations.

Measured Scrutiny (Universal Demand)

Under the MBCA, an SLC (of at least two independent directors) may seek dismissal of derivative litigation after a shareholder has made the obligatory pre-suit demand. If the committee was appointed by a majority of independent directors, the MBCA requires the court to dismiss the action under the same standards as board dismissal—namely that the SLC determines in "good faith" and after a "reasonable inquiry" that maintaining the suit is not in the corporation's best interests. MBCA §7.44(a), (b)(2). The same definition of independence applies for dismissal by the board. See *Einhorn v. Culea,* 612 N.W.2d 78 (Wis. 2000) (independence depends on whether committee member can decide "on merits of the issue rather than on extraneous considerations or influences"). A director is not disqualified merely because he is named as a defendant, was nominated or elected to the board by defendants, or approved the challenged transaction. MBCA §7.44(c).

Whether an SLC satisfies these standards requires a factual inquiry into the committee members' disinterestedness, assistance by outside advisors, preparation of a written report, adequacy of their investigation, and

reasonable belief in their decision. See *Cuker v. Mikalauskas*, 692 A.2d 1042 (Pa. 1997) (adopting the procedures and deferential review standards of the ALI Principles, which the court noted is "a comprehensive, cohesive work more than a decade in preparation").

Federal Derivative Claims

When a derivative suit involves federal claims—such as under the federal securities laws—the Supreme Court has accepted as a matter of federal law that an SLC can dismiss the litigation provided dismissal is consistent with federal policy. In *Burks v. Lasker*, 441 U.S. 471 (1979), a shareholder brought a derivative action against several directors of a mutual fund and its investment advisor claiming violations of the Investment Company Act of 1940. The fund had purchased commercial paper of Penn Central Railroad just before it became insolvent. An SLC investigated the allegations that the directors and investment advisor had breached their duty of care. The SLC decided litigation was not in the fund's best interests and sought dismissal. The Supreme Court upheld the dismissal on the theory the suit on behalf of the fund was governed by the law of the state of the fund's incorporation, provided state law is not inconsistent with federal policy. In the case, the Court held that the 1940 Act did not forbid termination of nonfrivolous claims, and thus dismissal was not inconsistent with federal policy.

Examples

1. Owing-Indiana (O-I), a public company incorporated in an MBCA jurisdiction, manufactures glass containers. Last year O-I's board unanimously approved a $5 million loan to Glass Advocates Committee (GAC), a political action committee set up to stop a state referendum to ban disposable soda bottles. GAC was organized by Frank Jr., the son of O-I's CEO, Frank Sr. There were reports that GAC spent most of its funds paying its organizers. The GAC loan is now delinquent, and O-I has done nothing. Dottie, a long-time O-I shareholder, wants O-I to collect the loan. She asks you for litigation advice.
   a. Must Dottie first make a demand on the shareholders?
   b. Must Dottie first make a demand on the board?
2. Kerning International is a holding company incorporated in Delaware. Among its subsidiaries is wholly-owned Kerning Glass, a glass container

manufacturer, incorporated in Delaware. The Kerning Glass board also approved a loan to GAC, which is now delinquent. Phil, a long-time Kerning International shareholder, wants Kerning Glass to collect. He asks you for litigation advice.

a. Must Phil first make a demand on shareholders?
b. Must Phil first make a demand on the Kerning International or Kerning Glass board?
c. What litigation strategy do you recommend to Phil?

3. Dottie and Phil do not make demands on the relevant boards, and each files a derivative suit naming the board's directors. In response, each board considers whether to request dismissal. After a cursory presentation by the company's inside attorney who says the suit is "no more than the machinations of another gadfly shareholder," each board moves the court to have the suit dismissed.

a. Under the MBCA, how will the court respond to the O-I board's request?
b. Under Delaware law, how will the court respond to the Kerning Glass board's request?

4. After Dottie files her complaint, the O-I board considers appointing an SLC to investigate the claims of the complaint. This will avoid any questions about the role of Frank Sr.

a. What should the board do to maximize the effect of the committee recommendations?
b. What should the committee do to maximize the chances that its recommendations will be listened to?
c. The SLC issues a report recommending that Dottie's complaint be dismissed. Is the recommendation binding on the court?

Explanations

1.a. No. The MBCA has no requirement of a demand on shareholders.

b. Probably. The MBCA requires a complaining shareholder to exhaust internal remedies by making a pre-suit demand on the board. MBCA §7.42. Dottie can avoid making demand if there would be irreparable injury by waiting for the board to act during the 90-day waiting period. Dottie might argue that the ongoing dissipation of funds by GAC

makes time of the essence. Unless the suit proceeds immediately, the corporation may be unable to recover from GAC or its organizers.

Demand on the board is required even though the GAC loans might be characterized as a director's conflicting-interest transaction. See MBCA Subchapter F (§13.4.1). The universal demand requirement gives even nonindependent directors an opportunity to reconsider their position and saves the time and expense of litigating the demand issue.

2. a. Probably not. Although the Delaware statute requires the plaintiff plead her efforts to make a demand on the shareholders or the reasons she did not, courts have largely read this demand requirement out of the statute in public corporations. If the shareholder can show such demand would be expensive or delay the action, or if the wrong is nonratifiable, courts have excused demand on shareholders. Making a demand on Kerning International's public shareholders would be burdensome; a demand on Kerning Glass's shareholder (the holding company) would be essentially a demand on the parent board.

   b. Not necessarily. Delaware case law permits a shareholder to bring a derivative suit and argue that demand was excused as futile. In a double derivative suit, such as this one, in which the shareholder seeks to have the parent exercise the subsidiary's litigation rights, the Delaware courts have focused their demand analysis on the *subsidiary's* board. See *Rales v. Blasband*, 634 A.2d 927 (Del. 1993) (look to subsidiary board because its decision is being challenged). Under *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (see §18.5.3), Phil would have to plead particular facts that created reasonable doubts about either the lack of independence of the subsidiary's current directors, or the validity of the loan and its forgiveness. Although the sketchy pleadings are insufficient under Delaware case law to create doubts about the subsidiary directors' disinterestedness or independence, the subsidiary's forgiveness of a political loan may be illegal (see §12.3.1) and thus unprotected by the business judgment rule. Demand would be excused.

   c. Phil should file suit and not make demand. In Delaware, a shareholder who makes a demand concedes that a majority of the board has the requisite disinterest and independence to respond to the demand and decide the fate of the shareholder's claim. That is, a demand on the

board shifts the corporate voice to the board. If Phil makes a demand, he can continue his claim only if he shows the board's response to the demand—whether inaction or settlement of the claim—was not protected by the business judgment rule. That is, he would have to show the board was grossly uninformed or lacked any rational basis for its response. If Phil files suit and argues demand was excused, he must plead particular facts to create the doubts of *Aronson v. Lewis* (see previous answer).

3. a. Under the MBCA, assuming demand was excused because otherwise there would be irrevocable harm, the court must dismiss the suit if a majority of the board is independent and sought dismissal in good faith after a reasonable inquiry. MBCA §7.44. Under the doctrine of res judicata, the GAC loan controversy would then be precluded from further judicial review in any court. If the court determines a majority of the board was independent, judicial review approximates that under the business judgment rule. That the O-I directors were named by Frank Sr. or have been named as defendants does not necessarily cause them to not be independent. The burden will be on the shareholder to show the board acted insincerely or without sufficient information. The official comment clarifies that the board need not engage outside counsel or advisors if it has knowledge of the pertinent facts or reasonably relies on others. The board could dismiss if it honestly and reasonably believed Dottie was "another gadfly shareholder."

   b. If demand was required, the court will dismiss the action unless Phil can show that the board's decision to dismiss was grossly uninformed or irrational, thus not protected by the business judgment rule. If demand was excused, the board's dismissal request will have no effect. Demand excusal carries with it the assumption the board lacks the independence to make a dismissal request or the allegations are sufficiently serious that the board could not request dismissal in good faith.

   In Delaware, the board's capacity to entertain the demand depends on a lack of interest among a majority of current directors and their independence of interested directors. See *Rales v. Blasband,* 634 A.2d 927 (Del. 1993). A director is considered interested if he will receive a personal financial benefit from nonprosecution of the suit that is not equally shared with the shareholders. For example, a director facing a

significant potential for personal liability is disqualified. A director lacks independence if he is "beholden" to interested persons. For example, an executive whose substantial salary depends on the favor of an interested person lacks independence.

4. a. The committee should be composed of directors who have no connection to the loan approval—either because they did not participate in the decision or were elected afterward. The committee should be given full power to hire outside advisors and to bind the corporation. Its recommendations should not be subject to review or approval by the board.

   b. The committee must create the appearance that it has fully investigated the charges of the plaintiff's complaint. It should conduct a discovery-like investigation: hire a prestigious unaffiliated special counsel (such as a retired judge or law professor), interview relevant people, review documents, and seek other knowledgeable and expert advice. The committee should carefully document its investigation and the basis for its recommendations.

   c. Probably. If a majority of the whole board was independent when the SLC made its recommendation, Dottie would have the burden to overcome a business judgment presumption and show the SLC members acted insincerely or without adequate information. Even if a majority of the whole was not independent, but the committee members were, the SLC has the power to seek dismissal, but it would have the burden to show its recommendation is protected by the business judgment rule. See *Carlton Investments v. TLC Beatrice Int'l Holdings, Inc.*, No. 13,950 (Del. Ch. May 30, 1997) (approving settlement negotiated by SLC, intended to stop spiraling litigation costs and end distraction of lawsuit). The SLC need not achieve perfection so long as it demonstrates independence, good faith, and a studied process.

   The MBCA's approach largely disregards the problems of structural bias on the board. Nonetheless, it is possible judges will review dismissal requests with greater scrutiny than under the normal business judgment rule. Just as a court has authority to consider the merits of the derivative suit when it approves a settlement, judges may feel inclined to delve into the SLC's "no sue" decision. See *Alford v. Shaw*, 358 S.E.2d 323 (N.C. 1987) (see §18.5.4). Judicial scrutiny of

the SLC's independence or its deliberations would recognize the self-interested motives of the possible voices in a derivative suit. This would be consistent with the logic in demand-required cases of the two-step *Zapata* test (see §18.5.4) and the general judicial rejection of the *Auerbach v. Bennett* business judgment rule approach (see §18.5.4).

Judicial scrutiny of the SLC recommendations assumes, as does the second step of the *Zapata* test, that inevitably judges will exercise their own "business judgment" concerning the litigation's merits to the corporation. Although some have argued that such decisions are not significantly different from ordinary business decisions and should not be left to judges, a strong argument can be made that judges are particularly capable of making judgments about the expected value of litigation—a task at which they are expert. In any event, judges are often called on to make business judgments when considering the substantive fairness of self-dealing transactions.

PART V

Shareholder Liquidity Rights

CHAPTER 19

Share Transferability—An Introduction

A fundamental aspect of the corporation is the right of shareholders to transfer their corporate shares. This chapter gives an overview of shareholder transfer rights under state law (§19.1) and summarizes how public trading markets function (§19.2). Other chapters in this part describe various limitations and protections surrounding shareholder liquidity:

- state law limitations on the sale of control shares (Chapter 20)
- shareholder rights to company disclosure, principally under federal securities law (Chapter 21)
- antifraud protection under federal Rule 10b-5 (Chapter 22)
- insider trading rules under state law and Rule 10b-5 (Chapter 23)
- federal liability for the disgorgement of insider trading profits (Chapter 24)

Share transferability also allows shareholders to sell their shares (and attached voting rights) to an acquirer in a corporate takeover. We discuss the techniques and the shareholder protections applicable to corporate takeovers in Chapters 34—39.

§19.1 SHARE TRANSFER RIGHTS

The proposition that corporate shares are freely transferable is so clear that most state statutes omit the point, describing instead the limited circumstances when transfers may be restricted. See MBCA §6.27; cf. Del. GCL §159 (corporate shares deemed "personal property and transferable").

Transfer restrictions cannot be imposed by majority action. According to state corporate statutes, they apply only to shareholders who purchased subject to the restriction or who are parties to a restriction agreement. See MBCA §6.27(a) (transfer restriction "does not affect shares issued before the restriction"). Any restrictions on share transferability must be for "reasonable purposes." See *Goldberg v. United Parcel Serv.*, 605 F. Supp. 588 (E.D.N.Y. 1985); MBCA §6.27(c) (maintain close corporation status, preserve securities exemptions). In practice, transfer restrictions are found mostly in closely held corporations. See §26.6.

An important issue in corporate takeover cases is whether defensive actions taken by the board of directors illegally restrict share transferability. For example, in *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985), shareholders challenged a "poison pill" rights plan under which the board issued rights to existing shareholders that were designed to substantially dilute the financial interest of any acquirer of more than 20 percent of the corporation's shares, unless the board chose to accept the acquirer's bid and redeem the rights. (This convoluted antitakeover device is described more fully in §39.2.3.)

In the case, the shareholders claimed the poison pill had the effect of discouraging an acquirer from making a tender offer, thus effectively preventing the shareholders from freely transferring their shares to such an acquirer. The Delaware Supreme Court assumed that a nonconsensual transfer restriction would be illegal, but concluded that the particular poison pill challenged in the case would not necessarily prevent outside bids. The court pointed out that similar poison pills adopted by other companies had not stopped takeover bids and that a persistent bidder could always engage in a proxy contest to replace the incumbent board and then, after redeeming the poison pill rights, proceed with a tender offer. Nonetheless, the court accepted the premise that any corporate action that prevented share transferability would be beyond the board's powers.

Note on Ramifications of Share Transferability

> Share transferability—which actually predates corporate limited liability—has important ramifications. First, shareholders can liquidate their investment in the corporation by selling their shares to new investors rather than drawing from the corporation—thus ensuring the continuity of corporate assets and permitting long-range business planning. Second, trading markets in corporate shares allow investors to cash out their corporate investment with relative ease—thus increasing the value of corporate shares both for investors and when the corporation raises capital. In fact, studies show that freely transferable shares are 25 to 40 percent more valuable to investors than identical, but transfer-restricted, shares. Finally, trading in corporate shares establishes market prices for corporate ownership interests—thus signaling to investors and management, as well as potential acquirers of corporate control, whether the corporate assets are being well managed.

§19.2 PUBLIC TRADING OF CORPORATE SECURITIES

The most significant characteristic of a public corporation is a market where shareholders can buy or sell the corporation's shares. The stock trading markets—sometimes known as "secondary markets"—account for about 99 percent of all share transactions. Only rarely do shareholders buy stock directly from a public corporation on what is known as the "primary market."

§19.2.1 Functioning of Public Stock Trading Markets

Suppose you have some money that you want to invest in stocks. How does stock trading work? As an individual investor you will rely on securities intermediaries to match your "buy" interest with another investor's "sell" interest. You can contact a stockbroker (a salesperson at a brokerage firm such as Merrill Lynch, which is now owned by Bank of America) and place an order for your account, such as a "buy" order for 100 shares of General Electric stock at the market price—that is, a *market buy order*. Or, more

likely, you can go online and place the same order on Merrill Lynch's website.

Once you've placed your order, Merrill Lynch can fill your order in several ways:

- **Exchange (auction) markets.** If the stock is "listed" on a stock exchange—the New York Stock Exchange in GE's case—Merrill Lynch (acting as your agent, or "broker") can relay the order to the "floor" of the exchange where trading occurs. Stock listed on an exchange is offered for sale and purchase by a single *specialist* in that particular stock, so there is always a seller to match every buyer. Your buy order will either be matched to another's sell order in a continuous auction or, if there is no matching order, the specialist will create a market by selling the stock himself at the then-prevailing price. Either way, you are assured of buying at the market price. The specialist's market-making role provides *continuity* and *liquidity*, thus preventing erratic price swings and assuring ready buyers and sellers. Along the line, Merrill Lynch and the specialist will charge you and the seller commissions for bringing you together.
- **Over-the-counter (dealer) markets.** If the stock is not listed on an exchange, Merrill Lynch can fill your buy order by using a computerized system that quotes available prices from other brokerage firms that sell for their own account. The principal system, known as the NASDAQ (originally, the National Association of Securities Dealers Automated Quotations System), is an *over-the-counter market* (OTC). Many stocks available on NASDAQ are not listed on exchanges. Merrill Lynch (acting for its own account as a "dealer") can use NASDAQ to buy stock for its account and then resell it to you at a mark-up. Some dealers (on average eight for NASDAQ stocks) act as *market makers*, performing much the same role as specialists on exchanges. Orders on the OTC markets are placed between securities firms by computer, rather than being routed to a central exchange. Instead of receiving a commission, Merrill Lynch will earn the spread—that is, the difference between its purchase price and its price to you. Although less common, Merrill Lynch also can act as a broker on an OTC market by purchasing stock from another dealer on your behalf and charge a commission for

acting as your agent. Merrill Lynch must tell you in which capacity it is acting.

- **Sell from inventory.** If Merrill Lynch owns GE stock, it can sell you the stock from its own "inventory." Whether it buys through NASDAQ or sells from its own account, however, the broker-dealer is supposed to execute at the best available price for the investor. If its sells from inventory, Merrill Lynch will make a profit or absorb a loss depending on the price at which it originally bought the stock. SEC rules require that the dealer's confirmation of the transaction disclose that it sold from inventory. Exchange Act Rule 10b-10.

Notice that these "buy" transactions take place in the secondary market, and do not involve General Electric. The only time you would buy directly from GE would be if the company issued stock in a public offering. In fact, some companies (including GE) now offer to their shareholders direct purchase programs in which shareholders can purchase shares (or reinvest dividends) without buying through a broker-dealer.

Electronic Trading

Today, individual investors can purchase securities with less reliance on securities intermediaries. For example, instead of calling a salesperson at your brokerage firm, you can place your order through E*Trade or other online brokers directly from your computer. In fact, all full-service brokerage firms like Merrill Lynch also offer online trading. Your order is then executed by the broker through an exchange, NASDAQ, or an electronic trading system.

Over the last several years, online electronic trading systems permit brokers, market makers, and fast-trading institutional investors to place large orders that the system automatically matches with other orders. These electronic communication networks (ECNs) have significantly lowered trading costs for investors and reduced the spread between buying offers (bids) and selling offers (asks).

Beneficial ("Street Name") Ownership

What record will you have that you own stock? Like most individual investors and more than 90 percent of all investors, you will not receive certificates for your stock. After your "buy" transaction closes—which now

must occur within three days after the trade is executed—your account with Merrill Lynch will be debited the purchase price (plus any commissions) and reflect that you own 100 GE shares. You will be the *beneficial owner* of these shares—but will not receive stock certificates from the company. Even if you ask, most companies today do not issue certificates. Instead, your ownership will be reflected on the books of Merrill Lynch, which will act as your *nominee*. As nominee, Merrill Lynch owns your stock in "street name." Your *beneficial ownership* does not show up on GE's shareholder records (which are kept by a transfer agent, usually a bank) because Merrill Lynch is the record owner of your shares. (The SEC has been considering a proposal for a direct-registration system in which transfer agents would electronically register securities under investors' own names.)

The "street name" system, though seemingly cumbersome, means your transaction (and thousands of others like yours) need not be recorded on GE's books. Proponents of the system point out that it is more efficient to consolidate the records of ever-shifting investments by listing Merrill Lynch as the record owner. Individual investors, as beneficial owners, retain the power to decide how their stock is voted and whether it should be sold. Under SEC rules, GE must ensure that proxy materials (printed or online) are made available to you directly if you consented to Merrill Lynch informing GE of your beneficial ownership, or indirectly through Merrill Lynch. See §7.2.5. You will exercise your voting rights either by voting online or filling out a proxy card made available from Merrill Lynch or by instructing Merrill Lynch how to vote on your behalf.

§19.2.2 Efficiency of Public Stock Markets

It is often said that many U.S. public securities markets, such as the New York Stock Exchange, are efficient. Those who make this assertion usually mean that the markets are "informationally efficient" and that prices at any time "fully reflect" all information "available" to the public. Simply stated, efficiency means that particular information affects the market price of a company's stock as though everyone had the same information at the same time. New information gets impounded in the stock price as though all investors simultaneously discovered the information and reached a consensus on a new price. In an efficient market, there are no opportunities for super-profitable trading strategies.

Do securities markets impound all information into prices?

Weak-Form Efficiency

Many kinds of information can affect stock prices. When a stock market impounds information about historic trading patterns so that investors can't draw charts of past prices to extrapolate future prices, the market is said to have "weak form" efficiency. A French mathematician noticed at the turn of the last century that prices on the Paris stock market exhibited "weak form" efficiency because stock price patterns were completely random, like the Brownian motion of particles suspended in a liquid. There was no way to guess the next move in the price of stock based on past patterns. Studies of prices on U.S. stock markets show the same "random walk."

Semi-Strong Efficiency

When a stock market promptly impounds all publicly available information, the market is said to have "semi-strong" efficiency. This means that ordinary investors can't beat the market systematically by using public information that affects stock prices—such as information on a company's earnings, competitors' products, government tax policies, changes in interest rates—because the "market" will already have discerned the information and reacted to it. In fact, a large body of evidence indicates public stock prices for widely followed companies in the United States change almost instantly and in an unbiased fashion (neither too much nor too little) in response to new public information. Often formal announcements of new developments, such as corporate earnings or new products, are already old news to public trading markets. "Semi-strong" markets behave like a herd of stampeding animals that instantly change course when just a few animals in the herd change direction—it is as though the herd has a single mind.

What are the trading mechanisms that rapidly transform new information into new prices to produce market efficiency? The answer lies in the activities of market professionals. A minority of knowledgeable traders who control a critical amount of trading volume can move stocks from "uninformed" to "informed" price levels. A critical mass of informed buyers and sellers (many advised by professional securities analysts), each trying to make money by outguessing the market, create a situation in which new information is almost instantly reflected in a new "consensus" on the stock price. Securities analysts follow the activities of larger public corporations, hoping to get an

informational advantage. Once an analyst identifies an information nugget, such as a confirmed rumor that a company will pay a larger-than-expected dividend, the analyst will immediately have his firm or clients trade. Just a few well-placed analysts, with others following their lead, can drive market prices.

Although analysts will beat the market a little over time, they will earn just enough to recompense their effort. The paradoxical effect of many analysts working assiduously to beat the market is that none can systematically beat it. The cap on trading profits is illustrated by the fact that managed equity mutual funds (which professionally invest in stocks for many small investors) on average only slightly outperform the market, but not enough to cover their fees.

Acceptance of semi-strong efficiency underlies important facets of U.S. corporate law. The business judgment rule, for example, assumes that if directors fail in their decision-making function, stock markets will impound this failure into the company's stock price—leading to discipline in the form of reduced executive pay, proxy contests, and takeover bids. See §12.2.2. The disclosure philosophy of the federal securities laws assumes that if some investors receive full and honest disclosure, the information will be impounded in the stock price—thus ensuring that all investors trade on the basis of a fair price. See §5.1 (disclosure in public offering), §21.2.2 (periodic disclosure by public companies). Even the Supreme Court has used the hypothesis of efficient capital markets to create a presumption that material misinformation to some (but not all) investors in a public stock market establishes that all investors who traded relied on the deception. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (see §22.3.3).

Despite some evidence of semi-strong efficiency in U.S. stock markets, there are disturbing incongruities. For example, studies show systematic mispricing over time of smaller or high-risk companies. In fact, studies suggest that stock markets (like the humans behind them) have a preternatural tendency to take risks even in the face of contrary information. Two recent examples in the U.S. markets undermine the argument that stock markets always behave rationally—the "irrational exuberance" (particularly in technology stocks) during the late 1990s, and the failure in the financial sector to recognize the risks of subprime mortgages, leading to the financial crisis of 2008. Sometimes stock markets seem unable to process obvious information.

Strong-Form Efficiency

One thing to bear in mind is that the public stock markets are not perfectly informationally efficient. That is, public stock markets do not impound *all* information that affects stock prices; they do not exhibit "strong form" efficiency. Evidence of this is that corporate insiders, who often have access to information not available to outside investors, can reap significant trading profits by exploiting market ignorance of their inside scoops. See Chapter 23 (Insider Trading).

Informational versus Fundamental Efficiency

Even if the public stock markets exhibit weak or semi-strong efficiency for many U.S. public corporations, stock markets and stock prices are not necessarily efficient in allocating capital. Just because General Motors is trading at $28 does not mean your future returns will justify spending $28 per share or that it is socially desirable that you pay $28 for General Motors shares as opposed to $28 for shares of Raleigh Bicycles. Informational efficiency does not translate into "fundamental efficiency"—that is, the optimal pricing and allocation of capital in society. It just means that the public stock markets act like a herd of stampeding animals so it is as though there is only one organism, not many individuals. Informational efficiency doesn't mean the herd isn't heading over a cliff.

CHAPTER 20

Limitations on Control Sales

Corporate control is a valuable commodity. A shareholder that holds a controlling interest can direct management of the business. But with control comes responsibility to other corporate constituents.

This chapter considers the prohibition against the sale of a corporate office (§20.1) and the limitations on the transferability of control shares (§20.2).

§20.1 SALE OF OFFICE

Directors and officers are strictly prohibited from selling their offices for personal gain. *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971). Corporate offices do not belong to the incumbents—officers are accountable to the board, and directors are accountable to the shareholders. As fiduciaries, corporate managers are bound to perform their functions under the terms of their appointment.

§20.2 LIMITATIONS ON SALE OF CONTROLLING SHARES

§20.2.1 Control Premium

The trading price of corporate shares does not always reflect fully their latent power (when combined with other shares) to exercise control. Normally, individual shares cannot alone affect control. But when a buyer accumulates enough shares for a voting majority, control value attaches to the shares. The difference between the value of latent control rights and the value of voting control is referred to as a "control premium."

What is a control premium? It is the additional value, above the financial value of a passive corporate investment, that comes with controlling the corporation's business. Suppose GenSys has 10 million shares outstanding and individual shares trade publicly at $50. Barbara, the largest shareholder, has 3 million shares. What is the value of her holding? Probably more than $50 per share because a 30 percent shareholder of a public company generally has effective control. If Kendall wants to buy Barbara's shares, Barbara will demand extra for her control block. Kendall will pay this premium because of the increased value to him of being able to extract greater returns from GenSys than if he owned a noncontrolling interest. Suppose Kendall pays $240 million, or $80 per share, for Barbara's shares. Her control premium is the $90 million difference between the sale price and the prevailing market price of her shares—a difference equal to $30 per share.

Note on What Constitutes a Controlling Interest?

Generally, a controlling interest is one in which a shareholder, whether an individual or a parent corporation, has sufficient voting power to determine the outcome of a shareholder vote—whether to elect a board majority or decide a matter presented to shareholders. See §17.1. In close corporations, this may require a shareholding of more than 50 percent—a majority shareholder. In a public corporation with widely dispersed shareholders, it may be enough to control as little as 20 percent of the voting shares and have the support of the incumbent board —a dominating shareholder. ALI §1.10(b) (presumption of control with 25 percent shareholding); but see *Williamson v. Cox Communications, Inc.*, 32 Del. J. Corp. L. 307 (Del. Ch. 2006) (concluding that

shareholder with less than 50 percent interest not controlling, unless shareholder actually exercises control over corporation, beyond installing directors or exercising veto).

§20.2.2 No-Sharing Rule

Generally, shareholders can sell their shares at whatever price they can get—including at a premium not available to other shareholders. Controlling shareholders need not share the premium their control block commands. *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387 (N.Y. 1979).

Some commentators have criticized this no-sharing rule. They have urged an "equal opportunity" rule under which all shareholders would share pro rata in any control premium. They argue that control should be viewed as a corporate "asset" in which each shareholder should share equally. See Berle, *The Price of Power: Sale of Corporate Control*, 50 Cornell L.Q. 628 (1965). Thus, a buyer willing to pay a premium for control (because the corporation's assets are more valuable in her hands) should be willing to pay the same premium for all the shares. See Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 Harv. L. Rev. 505 (1965).

Opponents of an equal opportunity rule argue that it would result in fewer (beneficial) control transfers and leave inefficient management entrenched. A rule that would force a buyer to pay all shareholders a control premium would make the acquisition more expensive. Further, the buyer might be unable or unwilling to buy all the shares. Moreover, the rule would dilute the value of control held by existing controlling shareholders, for which they may have already paid a premium. These commentators argue that minority shareholders, on balance, would prefer a rule that resulted in efficient new management, even at the expense of not sharing in any control premium. Easterbrook & Fischel, *Corporate Control Transactions*, 91 Yale L.J. 737 (1982). Studies indicate that prices of minority shares in public corporations rise after the sale of control, even when the control buyer does not purchase minority shares. See ALI Principles §5.16, note 1.

Nearly all courts have rejected the equal opportunity rule—primarily because equal sharing would effectively require all control purchases to be by tender offer open to all shareholders and would discourage beneficial changes

in control. Nonetheless, an equal opportunity rule of sorts now exists for acquiring control in *public corporations*. Under federal rules, *tender offers* in public corporations must be open to all shareholders—the “all holders” rule. Exchange Act Rule 14d-10(a)(1). In addition, each shareholder must be offered the highest price paid any other tendering shareholder—the “best price” rule. Exchange Act Rule 14d-10(a)(2). For tender offers in public corporations, these SEC rules preempt the state no-sharing rule. See §38.2.

Nonetheless, when the controlling shareholder is a parent corporation that seeks to sell a partially-owned subsidiary, the subsidiary’s board need not accept whatever terms the parent negotiates with the third-party buyer. Instead, the subsidiary’s directors have duties to protect the interests of the minority shareholders—even though the shareholders have no ability to vote down the transaction or right to share in a control premium. See *McMullin v. Beran*, 765 A.2d 910 (Del. 2000) (requiring directors of subsidiary to reach “informed and deliberate judgment” that minority shareholders are receiving maximum value for their shares in merger with third-party acquirer, whether by tendering their shares in merger or seeking judicial appraisal based on subsidiary’s going-concern value).

§20.2.3 Exceptions to No-Sharing Rule

To discourage harmful transfers of control, state courts recognize exceptions to the general rule of free transferability. See Elhauge, *Triggering Function of Sale of Control Doctrine*, 59 U. Chi. L. Rev. 1465 (1992). Controlling shareholders cannot sell their control block in three situations:

1. The sale is conditioned on the controlling shareholder improperly selling corporate offices to the buyer.
2. The buyer had proposed to acquire the whole company, and the controlling shareholder recast the transaction as a control block sale.
3. The controlling shareholder has reason to believe the seller will “loot” the corporation after acquiring control.

Sale of Office

Often the seller of a control block will promise, as part of the sale, to give the buyer working control of the board. This is accomplished by the seriatim resignation of the seller’s directors, with each vacancy filled by the buyer’s

directors. Without such a promise, the buyer would have to conduct a special shareholders' meeting to elect his new board, or wait to buy until the next annual shareholders' meeting, or risk his investment until his board is seated.

Courts treat "board succession" promises as a prohibited sale of office if the challenger shows either: (1) the buyer did not acquire working control and could *not* have elected his own slate, *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962), or (2) the sales price exceeds the premium the control block alone commands, suggesting the price included a prohibited sale of office, *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955) (Swan, J., dissenting).

Usurpation of Corporate Opportunities

Some cases hold that a controlling shareholder cannot convert an offer made to the corporation into one to the shareholder alone. If the control buyer offers to deal with all shareholders on an equal basis, such as by proposing a merger or the purchase of all the corporation's assets, some courts hold that the controlling shareholder cannot divert this "corporate opportunity" to himself. But many courts permit controlling shareholders to sell their shares as they choose, regardless of whether the buyer might have been willing to deal with the corporation or all the shareholders. See *Tryon v. Smith*, 229 P.2d 251 (Or. 1951) (upholding sale by 70-percent shareholder for twice that paid minority shareholders, even though buyer had first offered to deal with all shareholders equally).

Sale to "Looters"

A controlling shareholder may not sell control if the seller has reason to suspect the buyer will use control to "loot"—that is, steal corporate assets or engage in unfair self-dealing transactions—the corporation and the shareholders (and other constituents) left behind. If the control seller has reason to suspect the buyer will loot the corporation, the seller becomes liable for any damages caused by the buyer, including any damage to the corporation's earnings power. Corporate recovery is not limited to the control premium the seller received.

When does a controlling shareholder have a reason to suspect a looter? Courts accept that too strict a duty discourages control transfers. The seller is not a guarantor of the probity of the buyer. Instead, the seller must investigate the buyer's intentions only when circumstances raise a *reasonable suspicion*

that looting will follow the sale. See *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941); *DeBaun v. First Western Bank & Trust Co.*, 120 Cal. Rptr. 354 (Cal. App. 1975). If circumstances surrounding the sale are suspicious and the seller fails to investigate or his investigation confirms the suspicions, the seller becomes liable for any losses to the corporation.

What factual circumstances create danger signals?

- **When price is too good.** Although a high price may merely reflect the buyer's view that the corporation is worth more in his hands than with the incumbents, an excessive premium should cause suspicion—particularly if the corporation has readily marketable assets. But courts give sellers a good deal of leeway. See *Clagett v. Hutchinson*, 583 F.2d 1259 (4th Cir. 1978) (holding that price of $43.75 per share, for shares that usually ranged from $7.50 to $10.00 per share, did not place the seller on notice of potential fraud on the corporation).
- **When buyer is dishonest or hurried.** If there is reason to believe the buyer is dishonest, the seller must make further inquiries. See *Harris v. Carter*, 582 A.2d 222 (Del. Ch. 1990) (even if the sellers themselves relied on misrepresentations by the buyer). In addition, if the buyer shows little interest in the company's business and urges that the transaction be closed quickly, the seller may be required to investigate the buyer's motives.
- **When buyer has bad business reputation.** If the seller knows the buyer has significant debts, outstanding liens against his other businesses, and fraud judgments against him, the seller should suspect that the buyer does not worry about how he makes his money. *DeBaun v. First Western Bank & Trust Co.*, 120 Cal. Rptr. 354 (Cal. App. 1975).

§20.2.4 Meaning of *Perlman v. Feldmann*

The overlapping sale-of-control limitations are illustrated by the famous, much-studied case of *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955). Feldmann, who controlled 37 percent of the shares of Newport Steel, sold his shares for $20 per share—a two-thirds premium over the thenmarket price of $12. A minority shareholder brought a derivative suit on behalf of the

corporation, claiming Feldmann had sold a corporate asset, namely Newport's steel supplies, during the Korean War's steel shortage when steel prices were controlled and access to steel commanded a premium. Feldmann had invented a way to skirt the price controls (known in the industry as the "Feldmann Plan") by having buyers make interest-free advances to obtain supply commitments. The buyer (Wilport), a syndicate of steel end-users, wanted Newport's steel supplies free of the Feldmann Plan.

The court held that Feldmann had breached a fiduciary duty to the corporation because his sale of control sacrificed the favorable cash flow to the corporation generated by the Feldmann Plan. The court held Feldmann accountable to the minority shareholders to share his premium.

What did Feldmann do wrong?

- **Sale of office?** After Wilport bought Feldmann's control shares, Feldmann and the rest of the board resigned and installed Wilport's nominees. The court agreed that the price paid for Feldmann's shares was a fair one, negating any inference that Wilport had paid Feldmann to sell his office.
- **Denial of "equal opportunity" to share the control premium?** Although the Second Circuit's opinion contains broad statements about the duties of fiduciaries, the court's focus on the loss to the corporation from discontinuing the Feldmann Plan undermines this broad reading of the case. Other courts, including state courts in Indiana whose law the Second Circuit was purporting to interpret, have rejected an equal opportunity rule.
- **Sale to looter?** Wilport wanted a supply of steel free of the Feldmann Plan prepayment terms—that is, it planned to engage in self-dealing at controlled (below-market) prices. Feldmann no doubt knew this. The Second Circuit rejected arguments that gray market pricing under the Feldmann Plan was unethical and concluded that Wilport had taken a corporate asset by discontinuing Newport's gray market profits. Nonetheless, Newport's minority shareholders on balance benefited from the sale, as measured by post-sale increases in their share prices. That is, the loss of gray market profits was offset by the vertical integration with Wilport or its more efficient management. Wilport was on balance a beneficent new owner, not a looter.

- **Taking of a corporate control opportunity?** There was evidence that another purchaser had originally approached Feldmann to merge with Newport, a transaction through which all of the shareholders would have shared in any control premium. Feldmann rejected this offer and soon after sold his shares to Wilport.

Although the minority shareholders sued derivatively on behalf of the corporation, the Second Circuit allowed them to recover in their own right. Recovery by the corporation of Feldmann's premium would have allowed Wilport to recoup part of the premium it paid Feldmann for control (see §18.1.2).

Why is *Perlman v. Feldmann* relevant? The case has not been followed by other courts; the Second Circuit's holding is obscure; and its conclusion that the corporation suffered harm is belied by the remedy ordered. Nonetheless, the case offers a chance to think about corporate control, who owns it, and the role of fiduciary duties in the corporation. Some law professors believe the case offers enough to teach a whole Corporations course—perhaps they're right, but it would be a stretch.

§20.2.5 Disclosure Duties

Sales of control in public corporations must be disclosed under SEC rules. The corporation must disclose any sale of control within four days after it happens. See Item 5.01, Form 8-K (if known to the company's board) (see §21.2). And any acquirer of more than 5 percent of the company's shares must disclose the size of its holdings, along with information about itself, the sources of its funding, and its plans with respect to the corporation. See Schedule 13D (must be filed within 10 days after acquirer passes 5 percent threshold) (see §38.1).

In addition, controlling shareholders may have disclosure duties to minority shareholders. Controlling shareholders who know of an impending control offer and buy shares from minority shareholders cannot misrepresent their reasons for buying. See §23.2.1. What if they say nothing? Under the "special facts" doctrine, controlling shareholders may have a fiduciary duty to reveal material information when they purchase shares from minority shareholders in a face-to-face transaction. See §23.2.2.

Rule 10b-5 (the famous federal rule prohibiting securities fraud) also

imposes a disclose-or-abstain duty on controlling shareholders when trading on nonpublic confidential information in public and private markets. See §23.3.1. But a controlling shareholder who fails to tell minority shareholders that he is selling for a premium is not liable to them because they neither bought nor sold and thus lack standing to sue. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952) (same facts as *Perlman v. Feldmann* above).

Examples

1. Foamex Corp. makes foam for use in furniture. Stella, the firm's founder, owns 400,000 shares, representing 40 percent of Foamex's outstanding stock. Stella is getting on in years and has left management to her son-in-law Carl, the company's CEO and a 5-percent owner. There are 700 other shareholders for whom there exists a thin public trading market. Foamex stock has been trading at $20 a share.
   a. Boyer Inc., a large furniture manufacturer and Foamex's largest customer, wants to buy the company. Boyer offers to buy Carl's stock at $50 per share if he and the rest of the board resign and install Boyer's directors. Is this legal?
   b. Carl rebuffs Boyer, which then approaches Stella to buy her 40-percent block for $30 a share. What must Stella do before selling?
2. Boyer had originally approached Carl with a proposal that Boyer acquire Foamex in a $25 million merger—$25 per share. Carl told Stella about the offer, and she said the price was too low. Carl rejected Boyer's offer.
   a. Soon afterward, Stella suggested to Boyer that she would sell her 40-percent block for $12 million—$30 per share. Stella points out that this would be less expensive than Boyer acquiring control in a $25 million merger. Do you see any problems?
   b. Suppose Carl had informed the board of Boyer's merger offer, and the board had turned it down because the price was too low. Does this change things?
   c. A court holds Stella liable for selling her shares after Boyer's merger offer. Stella sold her shares for $12 million, at a time their aggregate market price was $8 million. In the merger she would have received $10 million. What is the appropriate remedy?

3. Soon after buying Stella's 40-percent block, Boyer buys Carl's 5-percent holding for $30 per share. Boyer bought on the condition that Carl use his best efforts to have the other board members resign and install Boyer's slate of directors.
   a. On what theory could Shawn, a Foamex shareholder, challenge Carl's sale.
   b. Evaluate the merits of Shawn's challenge.
4. After installing its own board, Boyer increases its foam purchases from Foamex and takes significant volume discounts not available to other Foamex customers or in the industry. This pattern is not new. Boyer has bought control positions in other suppliers to obtain supply discounts. Stella knew about Boyer's past practices.
   a. Shawn sues Stella. On what theory?
   b. Does Shawn have recourse against anyone else?
   c. A court finds Stella liable. To whom and for how much?

Explanations

1. a. No. Carl has sold his corporate office. Carl's 5-percent shareholding alone is insufficient to carry any meaningful control, particularly since Stella owns a controlling 40-percent block. The premium over market that Boyer is willing to pay can only be explained as consideration for Carl's promise to help install Boyer's slate of directors. A shareholder could challenge the validity of the board's filling of vacancies.

   b. Nothing, unless she suspects Boyer will loot the company. Shareholders have significant autonomy to decide whether or not to sell their shares, and a controlling shareholder's duty to investigate is triggered only when there is reason to be suspicious.

   Are there any apparent danger signals here? The 50-percent control premium hardly triggers suspicion—courts have approved control sales with premiums of up to 300 percent. Boyer's status as a Foamex customer does not necessarily imply future supply arrangements will be unfair. Unless Stella had some reason to suspect Boyer planned below-market arrangements—for example, because she knew Boyer needed to cut its foam costs significantly to stay competitive—Stella would be under no obligation to investigate or to refrain from selling her shares.

2. a. Perhaps. Stella's sale could be viewed as the usurpation of a corporate control opportunity. A merger would have meant equal sharing of any control premium. When the buyer (as here) is willing to deal with all the shareholders, a sharing rule would not prevent this control transaction from going forward.

Nonetheless, an "equal opportunity" rule reallocates part of the control premium to the other shareholders and dilutes the value of the controlling shareholder's control block. The rule would put Stella in the untenable position of either rejecting the transaction or putting the merger to a shareholder vote and voting against it herself. Modern courts are not inclined to force sharing just because the buyer originally suggested a sharing transaction. Only if the seller fraudulently buys minority shares (a kind of insider trading) to resell them to the buyer do the courts impose a sharing obligation.

b. Perhaps. Arguably, the board's rejection of the merger freed Stella to take the opportunity herself. But the board's rejection of the merger, like the rejection of a corporate opportunity in which a director has an interest, should be reviewed as a conflict-of-interest transaction under a fairness standard if Stella anticipated selling her control block. Was the board sufficiently disinterested, independent, and informed? See §16.3.1.

c. Sharing of her control premium with the minority, even though the normal remedy for a fiduciary breach is recovery by the corporation. Requiring Stella to pay her control premium (or a portion of it) to the corporation would produce a windfall for Boyer—indirectly refunding it a portion of the control premium it had paid for Stella's shares.

Here, the failure to share breached a duty to the minority shareholders, and it would seem that any remedy should be tailored to address the theory of liability. There are two possible theories, leading to different damage calculations:

- Under an "equal sharing" theory—Stella improperly took a control premium—Stella would be liable for 60 percent of the premium to the other (60 percent) shareholders. This was the remedial approach in *Perlman v. Feldmann*. See §20.2.3. Stella's control premium was arguably $4 million (the difference between her $12 million sales price and her shares' $8 million aggregate market price), suggesting

a $2.4 million recovery for the other shareholders, who hold 600,000 shares—$4 per share.

- Under an “improper rejection” theory—Stella improperly blocked the merger—Stella is liable for the loss she caused minority shareholders. This is the difference between the proposed merger price ($25 per share) and the market price ($20 per share) —$5 per share.

3. a. Sale of office. Carl’s sale is prohibited if Shawn can show Carl’s premium ($10 per share over market) included a payment to relinquish his office. If so, Shawn can seek to have Carl share his premium.

   b. Shawn has a difficult challenge. Although a 5-percent block could not alone command a control premium, a 5-percent *incremental* block might have been of particular importance to Boyer, a 40-percent shareholder. The additional 5 percent would make it virtually impossible for the public shareholders to form an effective dissident block because it would take 91 percent of the public shareholders to outvote a 45-percent Boyer. On the other hand, the most significant impediment to Boyer exercising effective control is not Carl’s 5-percent share ownership, but Carl’s incumbency and the board’s control of Foamex’s proxy machinery. Nonetheless, courts are reluctant to accept the obvious: A “board succession” promise has value to a control buyer and forms part of the bargain. Only if there is some suggestion Boyer has bought the board’s replacement to abuse its control should a court intervene.

4. a. Sale to a looter. There are two issues: (1) Did Boyer’s self-dealing transactions constitute looting? (2) If so, did Stella have reason to suspect that Boyer would engage in them?

   Boyer’s self-dealing purchasing appears to be on terms unfair to Foamex—the purchases do not fall into a range of what would be expected in arm’s-length transactions (see §13.3.2). Yet overall Boyer’s ownership may not cause losses to Foamex. Looting liability is limited to the losses the new owner causes the company.

   Even if Boyer is a looter, Stella is liable only if circumstances suggested Boyer planned to engage in unfair self-dealing. Although Stella should have known Boyer planned to increase its purchases from Foamex, Stella had no apparent reason to suspect the purchases would

be on unfair terms. Stella was under no duty to investigate whether purchases from other Boyer-controlled companies were on unfair terms unless circumstances raised this suspicion.

b. Yes. He can also sue Boyer, as controlling shareholder, on a self-dealing theory (see §17.2).

c. Stella will be liable directly to the minority shareholders on a pro rata basis for their losses, not limited by the control premium she received. (Recovery in a derivative suit would indirectly reimburse Boyer.) These losses could well exceed (and, if the looter does what it intended, should exceed) any control premium. Stella would be liable not only for the actual losses from the self-dealing (here $2 million a year) but also any losses to Foamex's earning power (consequential damages).

CHAPTER 21

Disclosure in Securities Trading Markets

Information is the lifeblood of securities trading markets—and thus shareholders' transfer rights. State corporate law imposes minimal disclosure obligations on the corporation. Instead, shareholders' informational rights arise largely under federal securities law. The Securities Exchange Act of 1934 (Exchange Act) builds on the regulation of public securities offerings under the Securities Act of 1933 (Securities Act, see Chapter 5). While the Securities Act reflects a "truth in securities" philosophy, the Exchange Act reaches ambitiously for "integrity in stock markets."

This chapter describes the rules on corporate disclosure by publicly traded companies under state corporate law (§21.1) and under federal securities law (§21.2).

§21.1 STATE DISCLOSURE DUTIES

Statutory Disclosure

State corporate law imposes minimal disclosure duties on corporations. Besides requiring basic information in the articles of incorporation and barebones notice to shareholders when they vote, state corporate statutes generally have not required regular information to shareholders. An exception, adopted in some states, is a requirement that shareholders receive

an annual financial report. See MBCA §16.20.

Duty of Honesty

In 1998, the Delaware Supreme Court created a stir when it held that corporate managers have a state-based fiduciary duty not to knowingly disseminate false information to shareholders. *Malone v. Brincat,* 722 A.2d 5 (Del. 1998). The duty, the court held, arises whether or not the corporation is requesting shareholder action, and can be enforced by shareholders claiming individual losses or in a derivative action on behalf of the corporation. In *Malone,* shareholders alleged that company directors (aided by the firm's outside accountants) had knowingly overstated the firm's financial position in SEC filings and public reports over a four-year period—causing a loss of virtually all of the company's value.

The chancery court dismissed the claim because the misinformation had not come in a "request for shareholder action," the usual context for Delaware's "duty of complete candor." See §10.3. Worried about duplicating or usurping federal securities law, the chancery court concluded that release of inaccurate information was not a "corporate governance issue." The Supreme Court rejected this formalistic line-drawing. The court held the alleged facts, if properly pleaded, could support a claim (either direct or derivative) that the directors had knowingly misinformed shareholders, a violation of their fiduciary duties.

Although some commentators have labeled *Malone v. Brincat* a "duty of disclosure" case, the label is misleading. The court created no general duty to disclose information, but simply held that *whenever* managers communicate they must be honest. This "duty of honesty" is triggered whether the communication involves a request for shareholder action, compliance with federal disclosure requirements, or a voluntary press release. Honest communications ensure that shareholders can exercise their voting and transfer rights, as well as their fiduciary rights to discipline management indolence or disloyalty.

What is the relationship of *Malone v. Brincat* to federal securities law? Under the Securities Litigation Uniform Standards Act of 1998 (SLUSA), any class action alleging fraud in publicly traded securities must be brought in federal court under federal law; state claims are preempted. Securities Act §16(c); Exchange Act §28(f)(2). The Delaware court interpreted SLUSA, passed after the case had commenced, to not apply. But as to future cases, the

court pointed out that the federal legislation would not prevent "duty of honesty" litigation in state court. SLUSA excludes from its coverage derivative suits and state-based claims based on breaches of fiduciary disclosure obligations—the so-called Delaware carve-out. See §22.1.2. Nonetheless, a "duty of honesty" claim presented as a class action alleging merely management deception might not fit these exclusions.

Is a "duty of honesty" action more advantageous than a federal securities fraud action under Rule 10b-5? See Chapter 22. According to the Delaware court, a "duty of honesty" action (unlike a 10b-5 action) can be brought by shareholders who do not claim to have purchased or sold because of the false disclosure. But a "duty of honesty" action claiming loss in share value would require a showing of individual reliance on the alleged falsehoods—essentially foreclosing class actions using a "fraud on the market" theory permitted under Rule 10b-5. See §23.3.3.

A full comparison, however, is difficult because *Malone v. Brincat* left a number of questions unresolved.

- **Culpability.** Although the *Malone* court said directors cannot "knowingly" disseminate false information, it is unclear what level of culpability must be pled and proved. Must the plaintiff show actual knowledge of the falsehood or is it enough that the directors were negligent?
- **Breach of care or loyalty.** Whether a breach of the "duty of honesty" constitutes a breach of the duty of care or of loyalty affects whether directors can be exculpated from personal liability (see §12.5). What "corporate damages," if any, must be shown in a derivative action? This might be problematic if corrective disclosure returns stock prices to "true value."
- **Remedy.** *Malone* does not identify the remedy when the corporation deceives shareholders. Damages that assume shareholders had bought or sold prior to the deception (rescissionary damages) might be greater than the usual out-of-pocket damages under Rule 10b-5, which are based on the loss in market value caused by the dishonesty (see §22.3.4).

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§21.2 FEDERAL DISCLOSURE REQUIREMENTS

The federal regime of ex ante *mandatory disclosure* applies to companies whose securities are traded in public stock markets. These companies become subject to a panoply of regulation, some of which are described in other chapters:

- **Periodic reporting.** Registered companies must file *periodic disclosure* documents with the Securities and Exchange Commission (SEC). These companies (including those that have made a public offering under the Securities Act) are known as "reporting companies." See §21.2.2 below.
- **Recordkeeping.** To carry out their periodic reporting obligations, registered companies must *keep records* and maintain a system of internal accounting controls. See §21.2.3 below.
- **Proxy disclosure.** Shareholders of registered companies must receive information under the SEC proxy rules when management (or others) *solicits proxies* on matters requiring shareholder voting. See §9.2. For annual shareholder meetings, shareholders must receive the company's annual report.
- **Takeover disclosure.** Any person or group that acquires more than 5 percent of a registered company's equity securities must disclose its plans. See §38.1. Any person that makes a *tender offer* for the equity securities of a registered company is subject to substantive requirements and disclosure rules. See §38.2.
- **Insider trading disclosure and disgorgement.** Directors, officers, and 10-percent shareholders of registered companies must *disclose their trading* in the company's publicly traded *equity* securities and are liable to the company if they make profits (or avoid losses) from purchases and sales within any six-month window. See Chapter 24.

§21.2.1 SEC Registration

Companies must register with the SEC under the Exchange Act in two circumstances:

- **Exchange "listed" companies.** Companies whose *debt* or *equity* securities are listed on a stock exchange must register with the exchange, with copies to the SEC. Exchange Act §12(a) (prohibiting trading by broker-dealers on stock exchange in securities not registered). Stock exchange rules specify qualifications that issuers must satisfy to have their securities "listed" for trading on the exchange. The "listing" rules assure traders on the exchange that these companies meet certain sales, assets, and net worth thresholds.
- **OTC companies.** In 1964 Congress amended the Exchange Act to require registration of companies whose *equity* securities are publicly traded on the over-the-counter (OTC) markets. A company must register if it has a class of equity securities held of record by more than 500 shareholders and has total assets exceeding $10 million. Exchange Act §12(g); Rule 12g-1 (asset threshold increased to $10 million in 1996).

Once registered, a company may deregister only under specified conditions. For a fuller treatment of this topic, see §9.2.1 (proxy regulation).

§21.2.2 Periodic Disclosure

Registered companies become "reporting companies" and must file annual, quarterly, and special reports with the SEC. Exchange Act §13(a). This ongoing stream of information is used extensively in securities trading markets. There are three important Exchange Act filings:

- **Annual report.** Reporting companies must file annually, within 60 to 90 days of the close of their fiscal year, an extensive disclosure document that contains much the same information as a Securities Act registration statement when a company goes public—including description of company's business, management's discussion of risks, and audited financial statements. Form 10-K (for smaller businesses, Form 10-KSB).
- **Quarterly report.** Reporting companies must file quarterly, within 35 to 45 days of the close of each of the company's first three fiscal quarters, a report that consists mostly of updated (and unaudited)

financial information. Form 10-Q.

- **Special report.** Reporting companies must file a special report on specified, material developments. See Form 8-K. Significantly expanded by the SEC in response to post-Enron concerns (see Sarbanes-Oxley §409), Form 8-K has moved closer to a continuous disclosure system. Exchange Act Rel. No. 49,424 (2004).

In theory, these mandatory disclosures represent a "public good" available to all securities market participants. Without a system of mandatory disclosure, management might not be inclined to provide *for free* such fulsome information, and traders would be reluctant to pay for it if others could observe trading patterns to "pirate" their information. To assure an adequate supply of company-specific information, the reporting system is mandatory and the information it produces is available to all.

Reporting by "Public Issuers"

In addition to companies that must register their securities for trading under the Exchange Act, companies that have made a registered securities offering (*debt or equity*) under the Securities Act are also subject to the Exchange Act reporting requirements. See Exchange Act §15(d); Rules 15d-1 to 15d-17. These companies must commence reporting once their Securities Act registration is effective, even if their securities are not listed on a stock exchange and the company does not satisfy the size thresholds of OTC registration. Companies subject to reporting only by virtue of §15(d), however, escape other Exchange Act regulation applicable to other registered companies with respect to proxy solicitations, tender offers, insiders' short-swing profits, and takeover bids.

Certification of SEC Filings

As commanded by the Sarbanes-Oxley Act, the SEC has adopted rules requiring corporate officers of reporting companies to certify the annual and quarterly reports filed with the SEC. Sarbanes-Oxley §302. The CEO and CFO must each certify that he reviewed the report and, based on his knowledge, that it (1) does not contain any material statements that are false or misleading, and (2) "fairly presents" the financial condition and results of operation of the company—regardless of formal compliance with accounting principles. Exchange Act Rules 13a-14, 15d-14 (certification not applicable

to Form 8-K reports).

In addition, the CEO and CFO must certify they are responsible for establishing and maintaining "disclosure controls and procedures" that ensure material information is made known to them, and these internal controls must be evaluated before making their report. See §12.3.5.

Real-Time Disclosure

There is no requirement that reporting companies disclose all material information on a real-time basis. But there is a move in that direction. As revised in 2004, Form 8-K (special reports) requires filing and disclosure within four business days of the following events:

- **Operational events.** Entry into (or termination of) definitive material agreements, loss of significant customer, bankruptcy, or receivership
- **Financial events.** Acquisition or disposition of assets, results of operations and financial condition (such as interim earnings statements), direct financial obligations or obligations under off-balance sheet arrangements (or events triggering such obligations), restructuring charges, material impairments under existing agreements
- **Securities-related events.** Delisting or transfer of listing, unregistered sales of equity securities, changes in debt rating, material modifications to rights of securities holders
- **Financial-integrity events.** Changes in registrant's certifying accountant, nonreliability of previously issued financial statements or audit report
- **Governance events.** Changes in corporate control, changes affecting directors or principal officers (departure, resignation, removal, election, appointment), amendments to articles or bylaws, waivers of code of ethics
- **Executive pay.** Compensation agreements (attached to filing), compensation arrangements outside ordinary course of business

In addition, any voluntary company disclosure to some investors must be disclosed simultaneously to all investors, typically by simulcast or posting on the company's website. See Regulation FD (§23.3.4). Voluntary disclosures of interim financial data and press releases must also be "furnished" to the

SEC on Form 8-K (by being furnished and not filed, the report does not trigger statutory fraud liability).

EDGAR

In the mid 1990s, the SEC computerized its filing and disclosure system. Today all disclosure documents must be filed electronically using the EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system. EDGAR filings are available on the Internet, going back to 1994 for most companies. Securities markets, as well as corporate and securities lawyers, have found EDGAR to be invaluable. You can find and play with it on the SEC's website at *www.sec.gov.*

§21.2.3 Recordkeeping and Foreign Bribes

In response to revelations in the 1970s of U.S. companies doctoring their books and setting up slush funds to bribe highly placed foreign government officials, Congress passed the Foreign Corrupt Practices Act (FCPA) of 1978. Cracking down on lax internal controls by publicly held corporations, the FCPA amended the Exchange Act to require reporting companies to (1) maintain financial records in "reasonable detail" to reflect company transactions accurately and (2) put into place internal accounting controls sufficient to provide "reasonable assurances" of internal accountability and proper accounting. Exchange Act §13(b)(2).

The FCPA also prohibits reporting companies (or their officials) from paying bribes to foreign government officials to influence their official actions or decisions for the purpose of obtaining or retaining business. Exchange Act §30A(a). In recognition of the way the world works, however, the FCPA excludes from its coverage "routine" payola to lower-level government officials to facilitate their performing their duties. Exchange Act §30A(b). Violations can result in civil penalties and criminal prosecution—both of companies and individuals. Exchange Act §30A(g) (specifying fines and civil penalties, with caps ranging from $10,000 to $2,000,000, and prison sentences up to 5 years for "willful" violations by corporate officials; prohibiting corporations from paying fines imposed on corporate officials).

In 2002, responding to a wave of corporate and accounting scandals, the SEC adopted new rules that require reporting companies to establish and maintain an overall system of disclosure controls and procedures adequate to

meet the company’s Exchange Act reporting obligations. Exchange Act Rules 13a-15 and 15d-15.

CHAPTER 22

Securities Fraud — Rule 10b-5

Rule 10b-5, the securities antifraud rule promulgated under the Securities Exchange Act of 1934, is a bedrock of U.S. securities regulation. Every securities transaction lives under its protective shade and in its menacing shadow. For those who enter into securities transactions, the rule assures that relevant securities information is not purposefully false or misleading. For purveyors of securities information, it imposes standards of complete honesty that carry risks of heavy liability.

This chapter begins with an overview of Rule 10b-5 (§22.1) and then describes the nature of a private 10b-5 action: the persons and activities to which the rule applies (§22.2); the fraud elements that must be shown to establish liability (§22.3); the defenses that apply in a Rule 10b-5 action (§22.4); a comparison with other antifraud remedies (§22.5).

The next chapter covers the use of Rule 10b-5 as the principal regulatory tool against insider trading. Then Chapter 24 looks at the federal disclosure rules and short-swing disgorgement liability for market trading by specified insiders.

§22.1 OVERVIEW OF RULE 10B-5

§22.1.1 History of Rule 10b-5

Rule 10b-5 has been aptly described as "the judicial oak which has grown from little more than a legislative acorn." The rule's origins were humble. In 1942, faced with reports that a company president was making unduly pessimistic statements about company earnings while at the same time buying his company's stock, the SEC filled a regulatory gap. The antifraud provisions of the Securities Act of 1933 prohibited fraudulent *sales* of securities, but there was no specific prohibition against fraudulent *purchases*.

Using its authority to promulgate rules that prohibit "manipulative or deceptive devices or contrivances … in connection with the purchase or sale of any security" under §10(b) of the Securities Exchange Act of 1934, the SEC filled the "purchase" gap with Rule 10b-5, which states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud;
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

The SEC approved the rule without debate, with one SEC commissioner asking rhetorically: "Well, we are against fraud, aren't we?"

The regulatory acorn sprouted in 1946 when a federal district court in Pennsylvania first inferred a private cause of action under Rule 10b-5. See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). The implied 10b-5 action then grew and branched in the 1960s as federal courts used it aggressively to regulate not only securities fraud, but also negligent securities practices and corporate mismanagement. In the 1970s the Supreme Court pruned back this judicial activism and effectively limited the private 10b-5 action to securities deception. This pruning continued, though less dramatically, in the 1980s and 1990s as the Court dealt with issues of 10b-5 coverage and procedure.

Through all of this judicial shaping, the 10b-5 action has shown remarkable resiliency and has become a centerpiece of U.S. securities regulation. Its procedural advantages are many: nationwide service of process, liberal venue rules, and broad discovery tools. In 1995, however,

Congress enacted the Private Securities Litigation Reform Act (PSLRA) to limit perceived abuses in federal securities litigation, particularly 10b-5 class actions. While the number of securities class actions has remained stable (about 150—200 per year, see http://securities.stanford.edu) since the PSLRA was enacted, the substantive and procedural rules introduced by the legislation have discouraged the filing of 10b-5 class actions. In 2002, responding to Enron and other accounting scandals, Congress enacted the Sarbanes-Oxley Act and signaled a renewed commitment to securities fraud liability. See §11.5.1. Then in 2010, responding to the financial crisis of 2008, Congress enacted the Dodd-Frank Act, expanding the SEC's enforcement powers, including in actions arising under Rule 10b-5. See §11.5.2.

§22.1.2 Private 10b-5 Actions and SEC Enforcement

Section 10(b), unlike other antimanipulation and antifraud sections of the Exchange Act, does not specify a private remedy for violations of its rules. Despite the absence of a statutory mandate, it is now beyond question that Rule 10b-5 implies a private cause of action. See *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) (first case to impose 10b-5 liability, holding corporate insider liable for misrepresenting that business would not be sold when in fact insider planned to sell it at substantial profit). See also *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) (confirming existence of private action). Such claims may be brought only in federal district courts, which have exclusive jurisdiction over actions arising under the Exchange Act. See Exchange Act §27.

Rule 10b-5 is also a potent tool in SEC enforcement. Section 21 of the Exchange Act gives the SEC broad enforcement powers to sue in federal court to enjoin violations of its rules, including Rule 10b-5. Using this authority, the SEC has sought injunctions and other equitable remedies. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (judicial order establishing a fund from which contemporaneous investors could recover lost profits from illegal insider trading). The SEC can also recommend that the U.S. Justice Department institute a 10b-5 criminal action, a common occurrence in insider trading cases. See §23.3.

Madoff Scandal

One of the most high-profile securities frauds—a Ponzi scheme orchestrated by Bernie Madoff in which he used new investor money to pay returns to old investors—illustrates the reach and limits of Rule 10b-5. Madoff was a stockbroker who promised his clients, mostly wealthy individuals and large charities, steady returns using sophisticated hedging techniques. The scheme lasted for nearly 20 years. All told, about $65 billion (including fabricated gains) was missing from client accounts when the fraud was revealed in 2008. Although the SEC had received complaints that Madoff's investment model was "too good to be true," the agency failed to unearth the fraud. Instead, it came to light only when Madoff himself told his sons that his investment funds were "one big lie."

Here is a *partial* list of the more than 250 cases spawned by the Madoff fraud (many as reported by "The D&O Diary" blog):

- Federal prosecutors brought a criminal case against Madoff, charging him with securities fraud (including under Rule 10b-5); Madoff pled guilty in 2009 and is serving a prison term of 150 years.
- Investors in the Madoff funds sued in federal court (including under Rule 10b-5), claiming fraud in their investments in the Madoff funds and seeking to recover a portion of their losses from the bankrupt funds.
- Investors in "feeder funds" that invested in the Madoff funds brought various federal class suits (including under Rule 10b-5) against the feeder funds, their advisers, and their accounting firms.
- Investors in the Madoff funds sued the SEC (under the Federal Tort Claims Act) for "sheer incompetence" in failing to investigate the Madoff scheme.
- The Massachusetts secretary of state brought similar suits (under Massachusetts law) against different feeder funds, which had recorded phone calls from Madoff that began "This conversation never took place, okay?"
- A divorced man sued his former wife (under state law) to recover payments he made in their divorce to buy out her portion of their Madoff investments, now worthless.
- A pro se plaintiff, on behalf of Madoff, sued Britney Spears and Kevin Federline, alleging (under who knows what law) that Spears had "secret

affairs with Madoff in return for Saks Fifth Avenue gift certificates."

Interestingly, although many of the claims involve fraud in connection with investments that ended up with Madoff, the claims often avoid Rule 10b-5. Why is this? You will discover that claims based on Rule 10b-5 face a number of hurdles. Class actions under Rule 10b-5 are subject to discovery stays, as well as limits on who can represent the class; and 10b-5 plaintiffs must prove the defendant's knowledge of the fraud and the victim's reliance on false information. In short, although Rule 10b-5 casts a large shadow, there are numerous ways to get at securities fraud.

§22.1.3 Some 10b-5 Pointers

In your study of Rule 10b-5, some preliminary pointers are in order.

Pointer	Elaboration
Look to the language of the statute, not the rule.	You will notice that the operative language of §10(b) is different from that of the rule. Over time, courts have interpreted the enabling statute and its phrase "manipulative or deceptive device or contrivance" as being narrower than the rule. The statute controls, and the phrasing of the rule's prohibitions has become largely irrelevant. The Supreme Court has repeatedly turned to the statutory language to fashion the 10b-5 action.
Identify a securities purchase or sale.	Both §10(b) and Rule 10b-5 apply to "the purchase or sale of any security." Thus, 10b-5 actions protect both investors who purchase and shareholders who sell. Rule 10b-5 also applies whether the securities are publicly traded or closely held and whether they are subject to registration or exempt. Securities exempt from registration under the Securities Act and the Exchange Act — significantly federal, state, and local government securities — are subject to the antifraud coverage of Rule 10b-5. See Exchange Act §3(a)(12) (definition of exempted securities).
Identify deception "in connection with" the securities transaction.	Both §10(b) and Rule 10b-5 apply to "any person" who engages in prohibited behavior "in connection with" a securities transaction. There is no requirement of privity. Rule 10b-5 applies to persons (such as companies that issue false or misleading press releases) even if they are not parties to securities transactions so long as their behavior affects the transactions.
Check (quickly) for the use of jurisdictional means.	Both §10(b) and Rule 10b-5 hinge on specified jurisdictional means: use of an instrumentality of interstate commerce, the mails, or a national securities exchange. In most situations, this raises essentially a nonissue. Almost always a securities transaction will involve the mails or interstate facilities at some point. If a check must clear or a letter confirms a transaction, the mail will be used. Further, the Exchange Act explicitly treats intrastate phone calls as involving the use of an instrumentality of interstate commerce. Exchange Act §3(a)(17). It is difficult to imagine, outside of a law school exam (such as a face-to-face transaction for cash), a securities purchase or sale not involving jurisdictional means at some point in its initiation, negotiation, or performance. *(continued)*

Pointer	Elaboration
Check (with care) for procedural limitations imposed by the PSLRA.	Class actions claiming securities fraud under federal law (including Rule 10b-5) are a disfavored genre after the Private Securities Litigation Reform Act of 1995. The PSLRA seeks to discourage frivolous securities litigation. Among other things, it requires in a 10b-5 class action that the lead plaintiff be the "most adequate plaintiff," presumably the shareholder or investor with the largest financial stake in the class relief. The PSLRA imposes significant new burdens on lead plaintiffs and their counsel: heightened pleading requirements, stay of discovery while any dismissal motion is pending, shifting of attorneys' fees if the complaint lacks substantial legal or factual support, payment of a bond to cover any fees that may eventually be shifted, full and detailed disclosure of any settlement, and limits on the awarding of attorney fees.
Check whether the action is brought in federal or state court.	Actions claiming 10b-5 violations must be brought in federal district court. Exchange Act §27 (exclusive jurisdiction of "violations of this Act or the rules and regulations thereunder"). In addition, class actions alleging fraud involving publicly traded securities — whether under federal or state law — must be brought in federal court. Securities Act §16(c); Exchange Act §28(f)(2). This jurisdictional mandate was added by the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which responded to a perceived loophole that allowed plaintiffs to avoid the PSLRA rules by bringing securities fraud class actions in state court, where state procedures and substantive law are less demanding. See §21.1. Under SLUSA, however, class actions that allege fiduciary breaches under state corporate law may still be brought in state court — the "Delaware carve-out." Securities Act §16(d); Exchange Act §28(f)(3)(A); Gibson v. PS Group Holdings Inc., Fed. Sec. L. Rep. ¶90,921 (S.D. Cal. 2000) (permitting securities fraud class action that alleges state fiduciary breaches to be brought in state court, not limited to the company's state of incorporation).

§22.2 SCOPE OF PRIVATE 10B-5 ACTION

Although grounded in the elements and terminology of the law of deceit, the judge-made 10b-5 action varies from a garden-variety fraud action. Courts have interpreted §10(b) to impose limits on who can sue, who can be sued, and what counts as securities fraud—the subjects of this subsection. Moreover, courts have conservatively honed the elements of a private 10b-5 action to resemble a decidedly old-fashioned action for deceit, except to relax significantly the normal requirement of reliance (see §22.3). Finally, courts have fashioned defenses to a private 10b-5 action that go beyond those of a typical fraud action (see §22.4).

Layered on this court-created 10b-5 profile are the provisions of the

Private Securities Litigation Reform Act of 1995. Among other things, the PSLRA revamped 10b-5 class action procedures, called for the shifting of attorney fees as a sanction for baseless complaints, largely replaced joint and several liability with proportionate liability, and confirmed the elimination of aiding and abetting liability in private actions.

§22.2.1 Purchasers and Sellers: 10b-5 Standing

Birnbaum Doctrine

Only actual purchasers or sellers may recover damages in a private 10b-5 action. This standing requirement, often called the *Birnbaum* doctrine, avoids speculation about whether and how much a plaintiff might have traded. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952). Even if a false or misleading statement leads a person not to buy or sell, with results as damaging as actual trading, there is no 10b-5 liability.

In 1975 the Supreme Court affirmed the purchaser-seller requirement. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The case—famous for the Court's virulent doubts about 10b-5 litigation and a precursor to the PSLRA restrictions on securities fraud actions—involved the unusual allegation that a corporate issuer had made overly pessimistic statements to discourage potential purchasers. Under an antitrust consent decree, the issuer (a trading stamp company) was required to offer its shares at a discount to retailers harmed by its prior anticompetitive activities. One of the retailers that did not buy sued to recover damages on the theory the prospectus offering the stock was pessimistic intentionally to discourage retailers from purchasing.

Speaking for the Court, Justice Rehnquist said the language of §10(b) and the Exchange Act's definitions did not cover offers to sell but only *actual sales or purchases*. He pointed out that for nearly 25 years Congress had let the *Birnbaum* rule stand. Justice Rehnquist then launched into a diatribe against potential abuse of 10b-5 litigation. He speculated that an indeterminate class of nonpurchasers would bring vexatious litigation to extract settlements, in the process disrupting business and abusing civil discovery. In addition, he argued liability would be staggering if nonpurchasers could base a claim on the speculative assertion they *would have purchased* had disclosure been less discouraging.

Securities Fraud Actions by "Holders" in State Court

The 10b-5 purchaser-seller requirement has led "holders" of securities to bring securities fraud class actions in state court alleging that false or misleading statements led them *not to sell* their shares. These "holder" cases ran into SLUSA, which requires that all class actions alleging fraud "in connection with the purchase or sale" of securities be brought in federal court. See §22.1.2.

In 2006 the Supreme Court held that "holder" class actions brought in state court are preempted by SLUSA, even though they are also barred in federal court under the *Birnbaum* doctrine. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006). The principal issue was whether "holder" claims were "in connection with the purchase or sale" of securities. The Court, resolving a split in the circuits, decided they were. Noting that the *Blue Chip Stamps* policy against "vexatious" litigation also motivated the PSLRA restrictions on securities class actions, the Court concluded that SLUSA was intended to funnel such actions into federal court—and squelch them. The Court pointed out that "holder" claims (whether in federal or state court) raise factual issues of whether and how much the holders would have sold, the precise speculation *Blue Chip Stamps* had sought to avoid.

Lead Plaintiff (and Counsel) in 10b-5 Class Actions

The PSLRA, a successor to the *Blue Chip Stamps* antagonism toward private 10b-5 actions, sought to constrain 10b-5 class actions instituted by "professional plaintiffs" who own a nominal number of shares in many public companies and lend their names (for a bounty) to securities lawyers who sue whenever there are unexpected price swings in a company's stock. The PSLRA establishes procedures for the appointment of the lead plaintiff (and thus lead counsel) in securities fraud actions. After the filing of a securities fraud class action, the plaintiff must give public notice to potential class members inviting them to serve as lead plaintiff. The court then is to appoint as lead plaintiff the "most adequate plaintiff," which the statute presumes would be the investor with the largest financial interest in the action. Exchange Act §21D(a)(3).

These new provisions envision a prominent role for institutional shareholders, which typically will have the largest financial interest in securities litigation involving public companies. The provisions specifically

exempt institutional shareholders from limits on the frequency a particular investor can serve as lead counsel. See Weiss & Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053 (1995) (cited prominently in PSLRA's legislative history).

§22.2.2 Primary Violators: 10b-5 Defendants

There is no privity requirement under Rule 10b-5. Any person who makes false or misleading statements and induces others to trade to their detriment can become liable—a *primary violator*. See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). Significantly, corporate officials who make statements about the corporation or its securities expose the corporation to 10b-5 liability, even though the corporation does not trade.

Control Persons

The Exchange Act imposes joint and several liability on any person who controls a primary violator—such as the parent corporation of a subsidiary that engages in illegal activity—unless the control person shows it "acted in good faith and did not … induce … the violation." Exchange Act §20(a). Courts have interpreted the "good faith" defense as requiring the showing of an affirmative effort by a control person to prevent subordinates from committing securities fraud.

Courts have wrestled with whether, aside from the control person liability of §20(a), the general rule of *respondeat superior* applies to a corporate defendant when an employee of the corporation commits securities fraud in the regular scope of her employment. See *Pugh v. Tribune Co.*, 521 F.3d 686 (7th Cir. 2008) (holding no *respondeat superior* liability under Rule 10b-5 when employee who gave false newspaper circulation figures was not executive officer and false figures were meant to deceive advertisers, not shareholders). The Exchange Act imposes liability on "persons," defined to include a corporation—an entity that can only become liable through its agents. Thus, as some courts have persuasively pointed out, the Act already makes corporate principals liable under traditional agency principles, regardless of the corporate defendant's "good faith" efforts to supervise its employees. Viewed in this light, §20(a) is an additional grounds for vicarious liability beyond traditional agency principles.

Aiders and Abettors

Until 1994 lower courts had uniformly upheld aiding and abetting liability in private Rule 10b-5 cases against secondary participants, such as accountants who certified a company's false financial statements or lawyers who advised and gave "substantial assistance" to securities swindlers. In *Central Bank of Denver*, 511 U.S. 164 (1994), the Court read the "manipulative or deceptive device or contrivance" language of §10(b) to require that 10b-5 defendants engage in actual fraudulent behavior, not merely provide collateral assistance —thus *disallowing* private actions based on a theory of aiding and abetting. The Court pointed out that none of the other express private causes of action under the Exchange Act impose aiding and abetting liability and that, in any event, such liability has never been widely accepted under tort law.

Even though lower courts had uniformly assumed the existence of 10b-5 aiding and abetting liability before *Central Bank*, the Court concluded Congress had never approved these cases and suggested Congress could remedy the problem if the Court's reading were in error. Congress accepted the Court's invitation in a limited way, permitting aiding and abetting liability in SEC enforcement actions. The PSLRA expressly authorizes the SEC to seek injunctive relief or money damages against those who aid and abet a 10b-5 violation by knowingly giving "substantial assistance" to the primary violator. Exchange Act §20(e).

The Dodd-Frank Act gives the SEC additional authority to challenge aiding and abetting. Responding to lower court decisions requiring a showing of "actual knowledge" for such liability, Dodd-Frank adopts a "recklessness" standard in SEC aiding and abetting actions. Dodd-Frank §929M. Thus, securities professionals (such as attorneys, investment banks, accountants, financial analysts, and credit rating agencies) that may not meet the definition of "primary violator" in a private action may be subject to liability in an SEC enforcement action. See §12.3.

Primary Violators (and "Scheme Liability")

Central Bank holds that peripheral actors who engage in fraudulent (or deceptive) conduct on which a purchaser or seller of securities relies may be liable as a primary violator. A recurring question has been whether the "primary violator" standard extends to those who facilitate the fraud. Some lower courts since *Central Bank* have held secondary participants (such as

lawyers, accountants, and underwriters) could be liable as primary violators for their role in drafting and editing documents that contain misrepresentations, even though the participants were not mentioned and the documents were disseminated to investors by others. See *In re Software Toolworks, Inc. Securities Litigation,* 50 F.3d 615 (9th Cir. 1994). Other courts have held that primary violators must actually make the misstatement to investors or have it attributed to them. See *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998) (refusing to hold liable an auditor that privately approved false press report because report stated financials were unaudited and did not mention auditor).

And what about 10b-5 liability for those who participate in fraudulent schemes by, for example, entering into sham transactions used to generate false financial results—so-called scheme liability? In 2008 the Supreme Court rejected scheme liability in private 10b-5 litigation. *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148 (2008). The Court held that the suppliers and customers who allegedly helped a cable TV company artificially inflate its earnings could not be liable as primary violators in a 10b-5 action brought by the company's investors. Even though the suppliers/customers had misled the issuer's auditors by documenting sham transactions with the issuer, their misdeeds were held not to be actionable in a private 10b-5 action.

The Court pointed out that the supplier/customers owed no duty to the company's investors, and the sham transactions were not disclosed to the public—and thus investors could not have relied on the deception, a prerequisite for 10b-5 liability. Furthermore, the Court concluded that the suppliers'/customers' deception of the auditors was "too remote" from the issuer's fraudulent financial statements to support primary liability. In short, liability for the investors' full trading losses would have been disproportionate to their attenuated involvement in the company's fraud.

The *Stoneridge* Court noted that Congress, in the PSLRA, had placed various limits on private 10b-5 actions, including limiting aiding and abetting liability to SEC enforcement actions. Although the Court did not address whether private 10b-5 liability extends to "behind the scenes" lawyers and accountants who engineer securities deception without an attribution of their role, the case reflects the Court's misgivings about expanding the implied private 10b-5 action to cover additional parties and situations. Instead, *Stoneridge* puts pressure on the SEC and state regulators to investigate and

bring enforcement actions against secondary participants.

Lower courts have followed the *Stoneridge* lead, denying secondary liability for lawyers and other professionals who created or facilitated fraudulent transactions—provided they were unknown to the victims of the fraud. See *Affco Investments 2001 LLC v. Proskauer Rose LLP*, 625 F.3d 185 (5th Cir. 2010) (refusing to hold law firm liable in disallowed tax avoidance scheme because investors did not allege investors' awareness of or reliance on firm); *Pac. Inv. Mgmt. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) ("behind the scenes" law firm not liable for facilitating fraudulent loan transactions and drafting false offering documents, where false statements were not attributed to firm). In short, lawyers can orchestrate a securities fraud and escape 10b-5 liability—so long as they hide themselves from view.

Securities Fraud in Mutual Funds

In a recent decision with potentially significant ramifications for 10b-5 actions, the Supreme Court held in a 5-4 decision that only those whoactually "make" false or misleading statements can be liable under Rule 10b-5. *Janus Capital Group, Inc. v. First Derivative Traders,* 564 U.S.131(2011). In the case, the Court held that a mutual fund adviser was not liable under Rule 10b-5 for false statements in a fund prospectus because the fund, not the adviser, had made the false statements. The Court said that only those with "ultimate control" over the statements in the prospectus (the mutual fund itself) could be liable.

Somewhat unusual under its 10b-5 jurisprudence, the *Janus Capital* Court focused on the language of Rule 10b-5, which makes it unlawful for "any person … to *make* any untrue statement of material fact" in connection with securities trading. The Court determined that the investment adviser had not "made" the untrue statements in the prospectus, even though it was "substantially involved" in its preparation. The Court said it was bound to interpret Rule 10b-5 with "narrow dimensions," likening the relationship of the fund and fund adviser to that of speaker and speechwriter.

The decision seemed not to understand that mutual funds themselves have no staff or employees, but outsource all of their operations to the fund adviser. It is the fund adviser, in turn, that makes all investment decisions for the fund and prepares all fund disclosures, including prospectuses. Nonetheless, the court concluded that "corporate formalities were observed" and that the investment adviser had a corporate board different from the

board of trustees of the mutual fund, thus making them "separate legal entities." The Court stated that redistributing liability in securities cases based on a "close relationship" between investment advisers and the mutual funds they advise was not the responsibility of the courts, but rather Congress.

Despite what to many seemed a misguided result, the outcome might well have been different had the plaintiffs in the case alleged that the fund adviser was the "control person" of the fund. Under Exchange Act §20(a) (described above), control persons assume the Exchange Act liability of the entities they control, which is the case in a typical mutual fund structure where the fund adviser controls all aspects of the fund's operations, including its drafting of disclosure documents. Any 10b-5 liability of the fund thus becomes the liability of the fund adviser, where the "good faith" defense would be unavailable if the fund adviser's actions satisfy the 10b-5 culpability standard.

§22.2.3 Fraud "in Connection with" Securities Transaction

Section 10(b) and Rule 10b-5 prohibit deception "in connection with" the sale or purchase of securities. How close must the deception be to the securities transaction?

No Privity Requirement

Courts have not required privity in 10b-5 actions. Thus, corporate misstatements in situations when the corporation itself is not trading are actionable—provided it is foreseeable that the misstatements will affect securities transactions.

Beyond Privity

Courts have had some difficulty interpreting the "in connection with" requirement when securities transactions are part of a scheme of corporate misdeeds or professional malpractice. If the securities transactions are tangential to the fraudulent scheme, some courts have assumed the matter is better left to traditional state fiduciary, corporate, agency, and contract law—a federalism concern. Nonetheless, on the three occasions that the Supreme Court has addressed the 10b-5 "in connection" requirement, it has construed

it broadly and flexibly to further investor protection.

- **Stockbroker embezzlement.** Misstatements have been held to be actionable both as a breach of fiduciary duty and as a fraud "in connection with" securities transactions. *SEC v. Zandford,* 535 U.S. 813 (2002). In the case, the SEC brought an enforcement action against a stockbroker who had sold his customer's securities and pocketed the proceeds without the customer's knowledge or consent. The stockbroker argued that any deception of the customer was not in connection with the sales of securities from the customer's account because he had never misrepresented the value of the securities in the account. The Court rejected the sophistry and concluded the securities sales and the stockbroker's fraudulent practices coincided—with each sale furthering the stockbroker's fraudulent scheme.
- **Misappropriation of confidential information.** The fraudulent misappropriation of material, nonpublic information has been held to be "in connection with" securities trading based on that information. *United States v. O'Hagan*, 521 U.S. 642 (1997). In the case (discussed more fully in §23.3.1 and §23.3.3 below), a lawyer used information about a client's planned takeover bid and purchased stock in the target before the bid was announced. The Court concluded that the lawyer's unauthorized use of client confidences was deceptive and "in connection with" his securities trading. The fraud was consummated, according to the Court, when the lawyer traded on the information entrusted to him—thus, the securities transaction and the breach of duty coincided. Significantly, the Court commented that its interpretation furthered "an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence."
- **Fraudulent takeover scheme.** A complex scheme to acquire an insurance subsidiary by using the subsidiary's assets to finance the acquisition was held to state a 10b-5 claim. *Superintendent of Insurance v. Bankers Life & Casualty Co.,* 404 U.S. 6 (1971). In the case, the purchasers acquired the subsidiary's shares and then, to pay for them, had the subsidiary's board authorize the sale of approximately $5 million of U.S. Treasury bonds owned by the subsidiary. To cover their tracks, the purchasers used the subsidiary's Treasury bonds to finance

> their acquisition and left a mortgaged CD on the subsidiary's books. The Court held the scheme, which effectively misappropriated reserves meant to cover the subsidiary's insurance obligations, to be "in connection with" a securities transaction—namely the sale of the Treasury bonds. Part of the fraudulent scheme, according to the Court, was the deception practiced on the subsidiary's board when it authorized the sale of the bonds without the subsidiary receiving fair consideration. The subsidiary "suffered an injury as a result of deceptive practices *touching* its sale of securities as an investor."

Sale of Business

The Supreme Court has held that Rule 10b-5 applies to stock transactions in the sale of a business even though the purchaser is not investing as a shareholder but buying the business outright. *Landreth Timber Co. v. Landreth,* 471 U.S. 681 (1985). The Court rejected a "sale of business" doctrine, adopted by some lower courts, that a securities transaction is not involved when a company is sold in a 100 percent stock sale. The Court read Rule 10b-5 literally to apply to any purchase or sale of securities, including the sale of a business structured as a stock sale.

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§22.3 FRAUD ELEMENTS OF PRIVATE 10B-5 ACTION

Neither §10(b) nor Rule 10b-5 specifies the elements a plaintiff must show to be entitled to relief. Nonetheless, the Supreme Court has looked to the statutory language of §10(b) and insisted that Congress meant "fraud" when it said "any manipulative or deceptive device or contrivance." The plaintiff has the burden of showing the following elements, each of which tests whether the supplier of misinformation should bear another's investment losses:

10b-5 Elements	
Material misinformation	The defendant affirmatively misrepresented a material fact, omitted a material fact that made his statement misleading, or remained silent in the face of a fiduciary duty to disclose a material fact.
Scienter	The defendant knew (or was reckless in not knowing) the true state of affairs and recognized that the plaintiff might rely on the misinformation.
Reliance	The plaintiff relied on the misrepresentation. In 10b-5 cases involving a duty to speak, courts dispense with reliance if the undisclosed information was material. In 10b-5 cases involving transactions on impersonal trading markets, courts infer reliance from the dissemination of misinformation in the trading market.
Causation	The plaintiff suffered actual losses proximately caused by the misrepresentation.
Damages	The plaintiff suffered damages. Courts use a variety of theories to measure damages under Rule 10b-5. Punitive damages, though, are not available under Rule 10b-5.

The PSLRA modifies the court-made rule of joint and several liability in 10b-5 actions and specifies proportionate liability in some circumstances. Exchange Act §21D(g). Although "knowing" defendants remain jointly and severally liable for the plaintiff's full losses, "unknowing" (reckless) defendants are generally liable only for that portion of damages attributable to their share of responsibility.

§22.3.1 Material Deception

Rule 10b-5 prohibits false or misleading statements of material fact. Not only are outright lies prohibited, so are half-truths. This means a true, but incomplete, statement can be actionable if it omits material information that renders the statement misleading. Under the PSLRA, a 10b-5 complaint that alleges half-truths must specify which statements are misleading and why they are misleading. Exchange Act §21D(b)(1).

Deception in securities markets comes in many packages, encompassing far more than false or misleading statements. It includes securities trading that creates false impressions, as well as silence in the face of a duty to speak. Deception can also occur when a statement, though true when made, is superseded by new information that triggers a duty to update. Confirming the

breadth of Rule 10b-5, the Supreme Court recently held that Rule 10b-5 covers deception in an oral contract for the sale of securities, despite the difficulties of proof. *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, 532 U.S. 588 (2001). In the case, the seller of a securities option who secretly intended not to honor the option argued that there had been no deception as to the option's value. The Court brushed aside the argument and held the seller's secret reservation was misleading because "the option was, unbeknownst to [the buyer], valueless."

Materiality

Not all deception is actionable. To prevent allegations of bad information from being used as a pretext for shifting trading losses, courts require that the misinformation be material. The Supreme Court has held that a fact is material for purposes of Rule 10b-5 if there is a substantial likelihood that a reasonable investor "would" (not "might") consider it as altering the "total mix" of information in deciding whether to buy or sell. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (adopting a "probability plus magnitude" test for disclosures pertaining to possible future events, such as merger negotiations, by considering both probability that event might occur and the magnitude of its effect on stock price). In general, if disclosure of the information would affect the price of the company's stock, the information is material.

The PSLRA creates a safe harbor for forward-looking information (such as future plans, predictions, or projections) if they are identified as forward-looking and accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the forward-looking statement." Exchange Act §21E. The PSLRA safe harbor is in addition to the judicially created doctrine that disclosure that "bespeaks caution" (beyond boilerplate warnings) can negate the materiality of unduly optimistic predictions. See *Kaufman v. Trump's Castle Funding*, 7 F.3d 357 (3d Cir. 1993).

To obtain class certification in 10b-5 actions, plaintiffs need only allege (but need not prove) the materiality of the alleged misrepresentations. See *Amgen Inc. v. Connecticut Retirement Plans & Trust Fund*, 568 U.S. ___ (2013) (despite class plaintiff's burden to show efficient market in "fraud on market" case, see §22.3.3 below, materiality is "question on the merits" to be decided on summary judgment or at trial).

Duty to Speak

Normally, silence is not actionable under Rule 10b-5. Nonetheless, courts have imposed a duty to speak when defendants have a relationship of trust and confidence with the plaintiff. See *Chiarella v. United States*, 445 U.S. 222 (1980) (duty to disclose is predicate to 10b-5 insider trading liability). For example, bank employees who failed to tell shareholders that they could sell their shares for higher prices in a resale market, instead of the primary market offered through the bank, breached their duty to disclose. The bank, as transfer agent for the shareholders' corporation, had a relationship of trust that compelled it to speak fully about the shareholders' selling options. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). A duty to speak also arises when a closely held corporation deals with its shareholder-employees. See *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987) (holding securities firm liable for remaining silent when the firm repurchased the shares of an employee who resigned on the eve of a lucrative merger offer).

Silence is also actionable in connection with corporate activities in a limited number of circumstances: when the company itself is trading its own securities, when the company fails to correct misinformation it begot and that is actively circulating in the market, or when the company knows that insiders are trading based on information not available to the public. This means, for example, that a company need not comment on analysts' forecasts unless the company has become entangled with the analysts. See *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) (no duty to disclose projections by investment analysts if the company had not in some way created or validated them).

Duty to Update

In some situations, statements accurate when made become inaccurate or misleading because of subsequent events. Most federal circuits have held that there is a duty to update when forward-looking statements still "alive" in the market have become inaccurate. The notion is that a projection carries an ongoing assurance of validity and thus an implicit duty to supply new information as it becomes available.

For example, the Second Circuit has held that the public announcement of a plan to find a financial partner to mend an over-leveraged capital structure

triggered a duty to update when the company began to consider a dilutive stock offering as an alternative financing plan. *In re Time Warner Securities Litigation*, 9 F.3d 259 (2d Cir. 1993). In a similar vein, the Third Circuit has held that a company that had stated its policy to maintain a stable debt-equity ratio came under a duty to disclose negotiations of a merger that would have added significant new debt. *Weiner v. Quaker Oats Co.*, 129 F.3d 310 (3d Cir. 1997). But there is no duty to update periodic SEC filings, which speak only as of the date when made. See *Gallagher v. Abbott Laboratories*, 269 F.3d 806 (7th Cir. 2001) (no duty to update Form 10-K, which failed to mention FDA letter threatening compliance action when letter was dated eight days after filing of 10-K).

Corporate Mismanagement

Mismanagement by corporate officials can violate Rule 10b-5 if the mismanagement involves fraudulent securities transactions that can be said to injure the corporation. For example, when corporate insiders buy stock from the corporation and deceive those with whom they deal, a derivative suit can be used to enforce the corporation's 10b-5 rights.

But not every corporate fiduciary breach involving a securities transaction gives rise to a 10b-5 action. The Supreme Court has held that Rule 10b-5 only regulates deception, not unfair corporate transactions or breaches of fiduciary duties. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977). In the case, a parent company merged with its majority-owned subsidiary after giving minority shareholders notice of the merger and an information statement that explained their rights to a state appraisal remedy. The parent stated that a valuation of the subsidiary's assets indicated a $640 per share value, even though the parent was offering only $125 per share (which was slightly higher than a valuation of the subsidiary by the parent's investment banker). The Court held that unless the disclosure had been misleading, which plaintiffs did not claim was the case, no liability could result. An unfairly low price does not amount to fraud.

§22.3.2 Scienter—"Manipulative or Deceptive Device or Contrivance"

A plaintiff in a 10b-5 action must plead and prove the defendant's *scienter*, a

"mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). In *Hochfelder*, an accounting firm negligently failed to audit a company's accounting practices, which would have revealed that the company president had induced investors to put money into nonexistent escrow accounts and pocketed the money himself. Defrauded investors claimed the accounting firm's negligence enabled the fraud. The Supreme Court rejected the argument, previously accepted by several lower courts, that negligence is actionable under Rule 10b-5. It based its holding not on the language of Rule 10b-5, which actually supports such a construction, but instead on the enabling "manipulative or deceptive device or contrivance" language of §10(b).

This culpability standard is the same whether the suit is brought by the SEC or a private plaintiff and whether the suit seeks injunctive relief or damages. *Aaron v. SEC*, 446 U.S. 680 (1980) (scienter required in SEC injunctive actions).

Meaning of Scienter

What is scienter in a securities fraud action? Scienter means the defendant was aware of the true state of affairs and appreciated the propensity of his misstatement or omission to mislead. See *Sundstand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977) (defining scienter as involving "not simple negligence," but extreme departure from ordinary care). Showing scienter, which requires evidence of the defendant's state of mind and intent to mislead, is often difficult.

The Supreme Court in *Hochfelder* left open the question whether a showing of recklessness can satisfy the 10b-5 culpability standard. Lower courts have uniformly concluded that recklessness is sufficient to establish scienter under Rule 10b-5, when misrepresentations were so obvious that the defendant must have been aware of them. See *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999) (summarizing approaches in various circuits). Under this view, recklessness exists when circumstantial evidence strongly suggests actual knowledge. Some courts have even said the plaintiff must show "deliberate recklessness." See *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 979 (9th Cir. 1999) (interpreting the PSLRA to compel 10b-5 plaintiffs to plead "facts that constitute circumstantial evidence of deliberately reckless or conscious misconduct").

The existence of liability for recklessness was implicitly acknowledged in

the PSLRA, which creates different levels of liability for 10b-5 defendants. “Knowing” defendants are subject to joint and several liability, while “unknowing” defendants (presumably those who were only reckless) are subject to proportionate liability. Exchange Act §21D(g)(10) (see §22.3.5 below).

Pleading Scienter

Most 10b-5 actions are dismissed or settled. Frequently, dismissal turns on whether the plaintiff has adequately alleged scienter. In general, allegations of fraud must be pleaded “with particularity.” Fed. R. Civ. P. 9(b). More specifically, the PSLRA requires a complaint alleging securities fraud to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” Exchange Act §21D(b)(2).

The Supreme Court has interpreted “strong inference” to mean “more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308 (2007). In the process the Court rejected a “middle ground” approach that looked at all the allegations collectively, without comparing them. The Court said that a comparison of “plausible inferences” (of both innocent misrepresentation and intentional fraud) was necessary, and the inference of scienter must be “at least as likely as” any plausible opposing inference.

The Supreme Court thus concluded that the PSLRA pleading standard can be satisfied by pleading facts that create “cogent and compelling” inferences of scienter, provided these inferences are at least as strong as inferences of nonculpability. Significantly, the Court added that, as in any dismissal motion, the court must accept “all factual allegations in the complaint as true” and the complaint must be read as a whole. The Court majority also rejected the approach of two concurring justices who argued that the inference of culpability must be “more plausible” than the inference of innocence, or “more likely correct than not correct.” That is, the Court decided that a tie goes to the plaintiff!

§22.3.3 Reliance and Causation

Reliance and causation, elements of traditional common-law deceit, are also elements of a private 10b-5 action—though not an SEC enforcement action.

See *SEC v. Rana Research*, 8 F.3d 1358 (9th Cir. 1993). The reliance requirement tests the link between the alleged misinformation and the plaintiff's buy-sell decision—it weeds out claims where the misinformation had little or no impact on the plaintiff's decision to enter the transaction. The causation requirement, like proximate cause in tort law, tests the link between the misrepresentation and the plaintiff's loss—it weeds out claims where the securities fraud was not "responsible" for the investor's loss.

Reliance and causation are related. Each serves as a filter to ensure that the misrepresentations or omissions alleged by the plaintiff are causally linked to the plaintiff's actions and losses.

Reliance

Courts treat reliance as an element in all private 10b-5 cases, but relax the requirements of proof in a number of circumstances:

(1) Nondisclosure. When the defendant fails in a duty to speak—whether in a face-to-face transaction or an anonymous trading market—courts dispense with proof of reliance if the undisclosed facts were material. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (no reliance need be shown in face-to-face transactions when bank employees violated position of trust by failing to make material disclosures). The materiality of the undisclosed information indicates a reasonable investor would have considered it important, suggesting the plaintiff may have acted differently had he known the information. To require proof of reliance in a case of nondisclosure would impose a nearly insuperable burden on a plaintiff to prove reliance on something not said.

(2) Omitted Information. In cases of half-truths—omitted information that makes a statement misleading—courts are divided on whether reliance must be shown. The PSLRA, however, makes reasonable reliance an explicit condition for "knowing" securities violations and thus joint and several liability, whether the claim is based on a misrepresentation or an omission. Exchange Act §21D(g)(10)(A).

(3) Fraud on the Market. In cases of false or misleading representations on a public trading market—so-called fraud on the market—courts have created a rebuttable presumption of reliance. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (plurality decision). The theory is that those who trade on public trading markets rely on the integrity of the stock's market price. In an open and developed stock market, the efficient capital market hypothesis (§19.2.2)

posits that market prices reflect all publicly available information about a company's stock. On the assumption that material misinformation artificially distorts the market price, courts infer that investors have relied on the misinformation. This "fraud on the market" theory assumes that if the truth had been disclosed, investors would not have traded at the prevailing nondisclosure price.

To obtain class certification in a case based on "fraud on the market," the plaintiff must show that the market in which the class traded was efficient and that the alleged misstatements were made to the public. See *Erica P. John Fund, Inc. v. Halliburton Co.*, 563___U.S. (2011) (interpreting FRCP Rule 23, which requires in damages class actions that common legal/factual issues "predominate" over individual issues). The showing of an efficient market has turned on a variety of factors, such as trading volume, number of analyst reports, presence of market makers and arbitrageurs, whether company is an S-3 filer, and historic movement of stock prices in reaction to unexpected events.

After the plaintiff has made this showing, a defendant can rebut the presumption of reliance and avoid the "fraud on the market" theory by showing either (1) the trading market was not efficient, such as by showing that the challenged misrepresentation did not in fact affect the stock's price, or (2) the particular plaintiff would have traded regardless of the misrepresentation. *Basic Inc. v. Levinson*.

The "fraud on the market" theory, which makes possible the 150-200 securities fraud class actions filed each year, has been a bane for the corporate community. Do investors actually rely on market efficiency? From a policy perspective, are class actions a viable way to deter and remedy corporate misinformation in stock markets? In 2014 the Supreme Court revisited the "fraud on the market" theory and upheld the presumption of reliance where corporate statements are made in public stock markets. *Halliburton Co. v. Erica P. John Fund, Inc.*, 573___U.S. (2014) (*Halliburton II*). The Court held that when a plaintiff seeks class certification based on allegedly false corporate statements made in a public stock market, the defendants may *before class certification* "defeat the presumption of through evidence that an alleged misrepresentation did not actually affect the market price of the stock."

Whether *Halliburton II* affects securities fraud class litigation remains to be seen. Dismissal at the certification stage may well turn on what "event

studies" lower courts come to view as sufficient to satisfy the defendant's burden. (Event studies, typically prepared by an expert, provide statistical analysis of whether and how particular events affected stock prices—such as the effect on stock prices when a company issues corrective disclosure.) It is unclear whether defendants will have to show that corrective disclosure did not produce a market-adjusted *negative* effect or whether defendants satisfy their burden by showing that plaintiffs cannot prove such a negative effect.

Causation

Courts have required that 10b-5 plaintiffs show two kinds of causation to recover:

(1) Transaction causation. The plaintiff must show that "but for" the defendant's fraud, the plaintiff would not have entered the transaction or would have entered under different terms—a restated reliance requirement. Many courts equate transaction causation with reliance.

(2) Loss causation. The plaintiff must also show that the fraud produced the claimed losses to the plaintiff—a foreseeability or a proximate cause requirement. See *Bastian v. Petren Resources, Inc.*, 892 F.2d 680 (7th Cir. 1990) (no loss causation when losses happened because of market crash, not fraud). Normally, plaintiffs can establish loss causation by showing a change in stock prices when the misrepresentations were made and then an opposite change when disclosure corrects the false or misleading information. What if there is no price change when the corrective disclosure happens—is it enough to allege and prove that the purchase price was inflated? The Supreme Court has held that the plaintiff cannot simply allege losses caused by an artificially inflated price due to "fraud on the market," but must allege and prove actual economic loss proximately caused by the alleged misrepresentations. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005). In the usual case, this will be done by showing a drop in price at the time of corrective disclosure, creating a logical link between the misrepresentation and the loss. If there is no price drop or the shareholder has sold before the corrective disclosure, the plaintiff may be out of luck!

Despite the plaintiff's burden to prove loss causation at trial, the Supreme Court has held that 10b-5 plaintiffs need not establish loss causation to obtain class certification. Instead, a showing of materiality—which creates a presumption of reliance under the "fraud on the market" theory—justifies a finding under FRCP Rule 23 that common legal issues "predominate" over

individual issues. Thus, for purposes of class certification, it is enough that the plaintiffs have pled their investment losses were the result of the alleged fraud. *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S.___(2011) (*Halliburton I*) (finding sufficient plaintiff's pleading that losses resulted from falsified earnings reports, understatements of asbestos-liability risk, and overstatements of benefits of merger).

§22.3.4 Damages

Proof of damages is also an element of a private 10b-5 action. The Supreme Court has held, however, that a 10b-5 plaintiff need not establish a price impact to show commonality in a class certification. *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S.___(2011) (*Halliburton I*).

Private 10b-5 plaintiffs have a full range of equitable and legal remedies. The Exchange Act imposes only two limitations. Under §28 the plaintiff's recovery cannot exceed actual damages, implying that the goal of liability is compensation and effectively precluding punitive damages. Under §21D(e), added by the PSLRA, damages are capped according to a formula meant to disregard post-transaction price volatility unrelated to any misinformation.

Damages Formulas

Courts have adopted various damages formulas, though with no clear guidelines as to when each applies. Assume that a company issued a false press release at a time its stock was trading at $18. After the false statement, the stock rose to $25. When the company later corrected the false statement, the stock price fell to $15 and then continued to fall to $12. Consider how the following theories of damages might be used by a purchaser in the market at $25 who sells when the market price falls to $12.

- **Rescission.** Rescission allows the defrauded plaintiff to cancel the transaction. If the plaintiff sold, he gets his stock back; if he purchased, he returns the stock and the seller refunds the purchase price. Rescission is suited only to face-to-face transactions where the parties can be identified; this theory would not be applicable in our example.
- **Rescissionary (disgorgement) damages.** If rescission is not possible because the stock has been resold, rescissionary damages replicate a

cancellation of the transaction. A defrauded seller recovers the purchaser's profits—the difference between the purchase and resale price. A defrauded purchaser recovers his losses—again, the difference between the purchase and resale price. Under this theory, the purchaser in our example would seek $13 in damages.

- **Cover (conversion) damages.** Cover damages, like those in a tort conversion action, assume the plaintiff mitigates her losses by selling or reinvesting. They are the difference between the price at which the plaintiff transacted and the price at which the plaintiff could have transacted once the fraud was revealed. Under this theory, the purchaser in our example would seek $10 in damages.
- **Out-of-pocket damages.** This is the most common measure of damages in 10b-5 cases. The plaintiff recovers the difference between the purchase price and the true "value" of the stock at the time of purchase. This measure does not take into account any post-transaction price changes. Valuing stock in the abstract is often speculative, and many courts (including the Supreme Court in *Dura Pharmaceuticals*, above, §22.3.3) look to the price at the time of corrective disclosure as a measure of the "but for" price. In our example, the purchaser might argue that the "true value" of the stock when he purchased was $12, with damages of $13; the defendant might argue the "true value" was $18, with damages of only $7.
- **Contract damages.** Contract damages compensate the plaintiff for the loss of the benefit of the bargain. They are the difference between the value received and the value promised. This theory would not be applicable in our example.

Courts have not developed a unified theory of 10b-5 damages except to say that the theory of damages should fit the facts of the case. In cases involving claims by customers against securities firms, courts often impose rescissory damages on the theory the customers would not have transacted had they known of the fraud. But in cases involving false corporate reports that affect trading in the company's shares, courts have been reluctant to use rescissory damages because it overpunishes the corporate defendant in a falling market. *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335 (9th Cir. 1976) (Sneed, J., concurring in denial of class action certification). Moreover, even though out-of-pocket damages exclude the effects of extraneous price changes,

aggregating such damages may result in a significant recovery that penalizes nontrading defendants and exceeds that necessary for deterrence.

Damages Cap

When recovery is based on the market price of the security—as with out-of-pocket and cover damages—the PSLRA imposes a damages cap. Congress created the cap on the assumption that damages are typically computed as the difference between the transaction price and the market price on the date of corrective disclosure—a rough out-of-pocket computation. Concerned that this "crash price" might substantially overstate plaintiffs' losses for a company with highly volatile stock, Congress required that courts consider a longer, 90-day window for determining the market price. In theory, prices during this longer window will more accurately impound the corrected disclosure. Under new §21D(e), damages are capped at the difference between the transacted price and the average of the daily prices during the 90-day period after corrective disclosure.

Circularity of Corporate Liability

When a corporation is made liable for damages in a 10b-5 class action, the effect will often be the subsidization of one group of shareholders (or investors) by current shareholders. For example, if the class action involves falsely optimistic statements by management, class members induced to purchase over-priced stock will receive compensation from the corporation. Rarely do managers themselves contribute significant amounts to the settlement of 10b-5 class action claims.

The result is that one group of investors (current shareholders) subsidizes another group of investors (purchasing shareholders)—net of the litigation expenses paid to class counsel and defense counsel. For investors who are diversified, as most individual and institutional investors are, 10b-5 class action litigation imposes costs, but no *net* financial gains for shareholders. Only to the extent that corporate managers (specifically and generally) respond to 10b-5 litigation by improving disclosure and corporate governance might the system be seen as cost-effective. Although studies indicate that companies that settle 10b-5 class actions subsequently undertake corporate governance reforms and then financially outperform their peers, it is unclear whether the benefits of class litigation are worth the costs. Each year approximately 150—200 securities fraud class actions are filed in the United

States, most of them “classic” cases alleging corporate misrepresentations that resulted in dramatic stock price declines. See Stanford Securities Class Action Clearinghouse, available at *securities.stanford.edu* (includes pleadings, court filings, dismissals, and settlement data in all post-PSLRA securities fraud class actions).

§22.3.5 Nature of 10b-5 Liability

Courts in 10b-5 cases have traditionally imposed liability on a joint and several basis—each culpable defendant becomes liable for all of the damages awarded. Joint and several liability serves to deter securities fraud and assures compensation for its victims. Potentially liable persons, facing the risk of full liability, feel compelled to guard against securities fraud. And plaintiffs are assured full recovery if they can identify at least one deep-pocket defendant.

The PSLRA, however, eliminates joint and several liability for defendants who do not “knowingly” commit violations of the securities laws. Exchange Act §21D(f)(2)(A). Instead, the Act creates a system of proportionate liability based on each “unknowing” defendant’s proportion of responsibility. Exchange Act §21D(f)(2)(B). This liability scheme responds to concerns that tangential defendants in securities fraud cases (such as outside directors, lawyers, and accountants) with little or no responsibility for the fraud might be coerced by joint and several liability into settling out of fear that they might be found liable and forced to bear all the damages awarded the plaintiffs.

According to the PSLRA, a person commits “knowing” securities fraud when he makes an untrue statement or factual omission, on which others are likely to reasonably rely, with “actual knowledge” of the falsehood. Exchange Act §21D(g)(10)(A). Reckless conduct, by definition, does not constitute a knowing violation. Exchange Act §21D(g)(10)(B). In 10b-5 actions, the PSLRA liability system thus places significant importance on whether a defendant’s scienter was knowing or merely reckless.

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§22.4 DEFENSES IN PRIVATE 10B-5 ACTION

Not only do the procedures and elements of private 10b-5 actions reflect a judicial and legislative caution about permitting investors to shift their trading

losses on the basis of claimed misinformation, but additional defenses (some of recent vintage) further limit the advantages of 10b-5 litigation.

§22.4.1 Limitations and Repose Periods

In 2002, Congress established a new statute of limitations for private 10b-5 actions. Sarbanes-Oxley §804. Under the new provision, "a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws" must be brought within two years after the discovery of facts constituting the violation (the limitations period), but no later than five years after such violation (the repose period). 28 U.S.C. §1658(b).

The statute extended the prior judicially-imposed statute of limitations in 10b-5 actions—which had been one year after discovery of facts constituting the violation, but no later than three years after the violation. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (announcing a uniform federal limitations period for 10b-5 actions, which before had borrowed applicable state statutes of limitations).

So when is a plaintiff deemed to have discovered facts constituting the 10b-5 violation—thus beginning the §1658 two-year limitations period? At first, lower courts were divided. Some started the clock when the plaintiff became "constructively aware" of possible fraud, others only when the plaintiff had specific evidence establishing the elements of a 10b-5 claim. The Supreme Court resolved the split in *Merck & Co. v. Reynolds*, 559 U.S.663 (2010). In the case, the Court permitted Merck shareholders to pursue a 10b-5 claim against the company for misrepresenting the safety and commercial viability of Vioxx, a pain reliever that the company ultimately withdrew from the market. The Court concluded that the two-year limitations period of §1658 accrues either (1) when the plaintiff actually discovers the 10b-5 violation or (2) when a reasonably diligent plaintiff would have discovered the facts constituting the violation—including the facts indicating scienter. The Court rejected the argument that the limitations period begins to run when the plaintiff was put on notice that something was amiss, requiring further inquiry. Thus, the limitation period did not start with information indicating concerns about Vioxx's safety—but only when there was information indicating that Merck's statements were false *and* made with an intent to deceive.

§22.4.2 Contribution and Indemnification

Securities fraud often implicates a number of actors. Contribution permits a defendant who becomes liable for more than his share to compel other responsible persons (whether or not they were sued) to pay their share of the total liability. Indemnification permits a defendant who has become liable to compel another person bound by contract to assume some or all of the defendant's liability. Both sharing mechanisms have the effect to encourage settlements with 10b-5 plaintiffs because they assure defendants there will be a later mechanism for them to "settle up," and thus expedite compensation to fraud victims.

Contribution

The PSLRA expressly authorizes contribution actions by parties jointly and severally liable under Rule 10b-5—typically "knowing" defendants. Contribution shares, like proportionate liability, are computed according to the percentage of responsibility. Exchange Act §21D(g)(8). The PSLRA also authorizes contribution by "unknowing" defendants who become subject to proportionate liability, but are forced to pay other parties' uncollectible shares. Exchange Act §21D(g)(5). Contribution may be sought from any person, whether or not joined in the original action, who would have been liable for the same damages. These statutory rights clarify a contribution right earlier recognized by the Supreme Court. *Musick, Peler, and Garrett v. Employers Insurance of Wausau*, 508 U.S. 286 (1993).

Under the PSLRA, contribution claims must be brought within six months after a final nonappealable judgment, though "unknowing" defendants who make additional payments beyond their proportionate share have six months after payment to seek contribution. Exchange Act §21D(g)(9).

Indemnification

Courts have implied a right to indemnification for "passive" or "secondary" 10b-5 defendants against more culpable participants. Such indemnification, courts have pointed out, increases deterrence by shifting liability to deliberately deceptive participants.

§22.5 COMPARISON TO STATE LAW REMEDIES

State law provides several alternatives to a federal 10b-5 action. Shareholders can sue corporate managers for violating their "duty of honesty" if they knowingly disseminate false information that results in corporate injury or damage to individual shareholders. See *Malone v. Brincat*, 722 A.2d 5 (Del. 1998) (see §21.1). Although the Delaware courts have yet to clarify the elements of a "duty of honesty" action, one apparent advantage is the absence of a "purchaser or seller" standing requirement.

In addition, many state "blue sky" laws (named after scams where farmers who were promised rain got nothing but blue skies) contain civil liability provisions modeled after §12(a)(2) of the Securities Act. See Uniform Securities Act §§410, 605 (see §5.1.3). For example, the civil liability scheme of §410 provides for rescission of both securities sales *and* securities offers made by means of false or misleading communications, whether written or oral, subject to a "due care" defense. Thus, the standing requirement and traditional 10b-5 elements of scienter, specific reliance, and causation are all relaxed. Moreover, state blue sky laws generally provide for recovery of attorney fees.

State common-law deceit, though its elements are similar to a 10b-5 action, offers some advantages over its federal counterpart. State statutes of limitations may be longer (particularly under the "inquiry notice" standard applied by federal courts); many states have relaxed scienter requirements; most states permit punitive damages in egregious cases; and none imposes the pleading and class action barriers of the PSLRA.

Although the Securities Litigation Uniform Standards Act of 1998 requires that any class action alleging fraud in publicly traded securities must be brought in federal court under federal law (see Securities Act §16(c); Exchange Act §28(f)(2)), not all state claims are preempted. Securities fraud in close corporations involving privately held securities can be brought under state law; "duty of honesty" claims may be brought as derivative actions; and state "blue sky" claims can be brought by individual investors.

Examples

1. Last year ITM Corp. (whose common stock is publicly traded) issued

preferred stock to a group of institutional investors in a private placement exempt from registration under the Securities Act of 1933 (see §5.1.2). ITM is now experiencing financial problems—its annual revenues have dropped 25 percent, and it has discontinued paying dividends on the preferred. One of the investors, Lucre Life Insurance Company, thinks the offering circular accompanying the preferred issuance was misleading.

   a. Does Lucre Life have standing to bring an action under Rule 10b-5?
   b. Lucre Life is worried about delays in federal court. Can it sue in state court?

2. The offering circular stated: "ITM is committed to energy storage research and has spent over $200 million on this research in the last two years." Last year, ITM's total revenues were $25 billion.
   a. In fact, ITM had only spent $150 million on electrolysis research. Is there 10b-5 liability?
   b. The offering circular failed to mention that ITM's electrolysis research is a long shot and there is no assurance it will produce results having any commercial value. Is there 10b-5 liability?
   c. The offering circular also states that "the company anticipates that sales of our energy storage technology in the next fiscal year will exceed research expenses." Senior management, however, has doubts whether this will happen. Is there 10b-5 liability?
3. ITM's offering circular falsely stated the company had been awarded a large military contract to create solar-powered electrolysis systems that would separate water into hydrogen and oxygen (a highly efficient method to produce and store energy). In fact, the company was hoping to receive the contract, but its bid lost. Jane, ITM's outside attorney who prepared the offering circular, had been told by Daniela (ITM's president) that it was a "done deal," though Jane had an inkling that ITM had not been awarded the contract.
   a. Assuming the offering circular was materially false, can Lucre Life sue Jane under Rule 10b-5?
   b. Lucre Life alleges that Jane, though she did not actually know about the status of the contract award, suspected the contract had not been awarded and was in a position to know. Is this sufficient?

c. Nobody at Lucre Life actually read the portion of the offering circular mentioning the contract award. There is no organized market in ITM's preferred shares. Can Lucre Life recover against ITM under Rule 10b-5?

d. Lucre Life bought its preferred shares at $100. After it learned ITM had lost the bid, it sold the shares to another institutional buyer at $85. Assuming liability, how much can Lucre Life recover?

4. Lucre Life settles its lawsuit. Soon afterward, ITM research scientists conduct preliminary tests on a cobalt/phosphate film that has efficient electrolytic properties at room temperatures. If the tests can be confirmed, the discovery would be an enormous breakthrough with great commercial value. It would mean that solar energy could be efficiently stored, potentially making every house or building its own power plant and filling station.

   a. Must ITM issue a press release disclosing the tests?

   b. In the week after the tests, there is an unusual amount of trading activity in ITM's common stock, which rises in price from $50 to $70. A *Wall Street Journal* reporter calls Daniela, ITM's president, and asks if she can explain the recent price rise. Daniela does not believe there has been insider trading, and doesn't want to say anything. What should she do?

   c. ITM's management wants to put an end to media speculation and issues a press release stating, "There are no corporate developments that would explain the unusual recent market activity in ITM's stock." Would this violate Rule 10b-5?

   d. How should the press release have been drafted?

5. Sharon sells her ITM stock when the price falls after the false press release. More than two years later, after many further tests by ITM scientists and much speculation among securities analysts, ITM files a report with the SEC announcing its invention of a low-cost, efficient electrolysis process using a cobalt/phosphate film. The company's stock price soars. But Sharon no longer owns ITM stock. What a disappointment!

   a. ITM never purchased or sold its stock in connection with the original false press release. Can Sharon sue ITM under Rule 10b-5?

   b. Sharon was not aware of the original false press release, and ITM

argues her decision to sell was unrelated to it. Must Sharon show she acted in reliance on the press release?

c. Sharon sold her ITM stock more than two years ago. Would a 10b-5 action now be timely?

Explanations

1. a. Yes. Lucre Life has standing as a purchaser of securities even though they are not traded on a public trading market. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) ("purchaser" or "seller" standing requirement) (see §22.2.1).

   b. Not under Rule 10b-5. Jurisdiction over 10b-5 claims is exclusively in federal court. If the action were brought in federal court, any state fraud or blue sky claims could be brought as pendent claims. Many securities lawyers perceive federal judges to be more sophisticated in securities matters.

   Nonetheless, Lucre Life could sue in state court on a theory of common-law fraud or under state blue sky provisions whose elements are not as burdensome as those of Rule 10b-5. The preemption of the Securities Litigation Uniform Standards Act of 1998 does not apply because Lucre Life is not bringing a class action. See Exchange Act §28(f)(1) (preemption of "covered class actions").

2. a. Probably not. It is unlikely that the discrepancy was material. The $50 million difference between stated and actual research expenditures seems immaterial for a company with $25 billion in revenues. Lucre Life would have to show a substantial likelihood a reasonable investor would have considered the $50 million discrepancy important in its decision to invest at the offering price. For example, if the company's research activities were perceived to drive its stock value or if the company's stock price fell significantly when the discrepancy was revealed, materiality would be easier to argue.

   b. Probably not. It is unlikely that there was reliance. It seems unlikely a reasonable investor, particularly an institutional investor like Lucre Life, would have understood ITM's statement that it was "committed to energy storage research" to suggest the company was sure of commercial success. The "no assurance" caveat would not have added to the overall mix of information available to the investors.

c. Perhaps. Scienter is an element of a 10b-5 action. A mere misstatement is not actionable, unless it was made with scienter. Even though it may be difficult to establish corporate awareness that the prediction of future revenues was not likely to occur, scienter can also be established by showing "recklessness." Here the lack of a basis for believing that energy-storage revenues would cover research expenses suggests that the falsity of the statement was "so obvious that the defendant must have been aware of them." See §22.3.1.

3. a. Perhaps. Even though she was not a party to the stock sale, privity is not required under Rule 10b-5. Jane may be liable as a "primary violator" if she made false or misleading statements on which investors relied. (She cannot be liable in a private action on an aiding or abetting theory.) Some lower courts have held collateral participants liable as primary violators for their role in drafting documents that contained misrepresentations, even though others disseminated the documents to investors.

The Supreme Court's decision in *Stoneridge* (see §22.2.2) rejecting "scheme liability" under Rule 10b-5 suggests that investors must be aware of the alleged participant's role in the fraud. That is, merely preparing the disclosure documents—although necessary to carry out a fraudulent scheme—is not enough to establish private 10b-5 liability. This conclusion is reinforced in *Janus Capital* (see §22.2.2), which held that merely drafting a false disclosure document did not subject a mutual fund adviser to liability where the statements in the document technically were "made" by the fund itself. Thus, even if Lucre Life knew that Jane (and her law firm) had prepared the disclosure documents, it would seem Lucre Life cannot look to Jane, but only to ITM, for 10b-5 liability. And given that Jane (and her law firm) did not control their client, they would not be exposed to the client's 10b-5 violation as control persons.

This, however, is not the end of the story for Jane. Although probably absolved of direct 10b-5 liability, Jane (and her law firm) might be subject to liability *to ITM* for professional malpractice arising from her knowing assistance in a securities fraud. She might also face liability in an SEC enforcement action for "aiding and abetting" ITM's 10b-5 violation, potentially resulting in an injunction and fines that could be as devastating as direct 10b-5 liability. See Exchange Act

§20(e) (see §22.2.2).

b. Probably not. Even if Jane may be considered a "primary violator" (see previous explanation), Lucre Life must establish her culpability. She must have known or been reckless in not knowing the true status of the contract award. Negligence is not enough.

Are Lucre Life's allegations sufficient? The Supreme Court's decision in *Tellabs* (see §22.3.2) clarifies the PSLRA pleading standard for alleging scienter in a private 10b-5 action. The Court requires that the "plausible inferences" of nonculpability and fraudulent intent be compared, and the inference of scienter must be "at least as likely as" any plausible opposing inference. In this case, because Lucre Life is not alleging actual knowledge, it would have to show Jane's alleged *recklessness* is at least as likely as not.

Lucre Life's allegation that Jane suspected the disclosure was not true and was in a position to know the truth would seem to make out a claim of recklessness, at least as defined by the lower courts. Her suspicions would seem to create a "cogent and compelling" inference that the misrepresentations were so obvious she must have been aware of them. That is, circumstantial evidence strongly suggests Jane knew something was amiss and should have investigated, even if she did not actually know the true state of affairs. In a dismissal motion, the court must accept "all factual allegations in the complaint as true" and the complaint must be read as a whole.

The *Tellabs* approach effectively rejects the prior focus on the "motive and opportunity" of the defendant. Cf. *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000) (accepting pre-PSLRA pleading standard that strong inference of fraudulent intent can be established by alleging facts that show the defendant had both motive and opportunity to commit fraud). Thus, Lucre Life would not have to allege that Jane had a motive to deceive.

c. Perhaps. Reliance is an element of a 10b-5 action, and Lucre Life must show it acted on the basis of the circular's false statements concerning a government contract. This will be difficult because the plaintiff never read this part of the circular. Nor is there an open, developed, efficient market that sets the price for the preferred stock—undermining for the plaintiff a traditional "fraud on the market" theory of reliance.

Nonetheless, Lucre Life might argue that it relied on the private placement market. Some courts have accepted the argument that a plaintiff establishes reliance if it can show a new offering would not have been marketed *at all* if the investors had known the true facts. That is, Lucre Life could argue it relied on the other institutional investors' decision to buy. This theory nearly excuses reliance in any issuance of stock, and some courts have limited the theory to fraud that was "so pervasive that it goes to the very existence" of the securities on the market. *Ross v. Bank South, N.A.*, 885 F.2d 723 (11th Cir. 1989).

d. Lucre Life has a number of remedial theories to choose from, depending on which defendant it seeks recovery from. If the plaintiff seeks recovery from ITM for selling its securities through a false selling document, a rescissory theory avoids issues of valuation and post-transaction losses. It prevents unfair enrichment by ITM and compensates Lucre Life for losses it would not have incurred but for the fraud—which matches its theory of liability. Lucre Life can support a rescission theory by pointing to §29(b) of the Exchange Act, which states that any "contract made in violation" of any rule under the statute is void. Rescissory damages in this case would be the difference between $100 (the purchase price) and $85 (the price at which Lucre Life later sold)—$15 per share.

A rescission theory does not fit as well for Jane, the arguably complicit attorney. Jane was not the seller and was not unjustly enriched; heavy damages might overdeter her conduct. A cover theory —which assumes the plaintiff sells once the fraud is revealed—does not fit the facts because there was no market into which the plaintiff could sell or to measure the effect on price when the fraud was revealed. An out-of-pocket theory, the traditional theory for fraud damages, would allow Lucre Life to recover the difference between the purchase price and what the price would have been had the disclosure been adequate. This will require Lucre Life to prove the "true" value of the preferred stock as of the time of its purchase. Recovery will probably be less than $15 per share, given that it might be difficult for Lucre Life to show the price drop was due entirely to the misinformation about the contract award.

According to the Supreme Court in *Dura Pharmaceuticals* (see §22.3.3) a plaintiff alleging "fraud on the market" (against a nonprivity

defendant) must prove actual economic loss proximately caused by the alleged misrepresentations. Here the price drop is not clearly tied to misinformation in the offering circular. The burden is on the plaintiff to show proximate cause (loss causation).

In addition, damages will be capped by the difference between the $100 purchase price and the "average of the daily prices during the 90-day period after corrective disclosure." See Exchange Act §21D(e) (see §22.3.4—Damages Cap).

4. a. No. Rule 10b-5 does not require disclosure of all material information. Only if ITM has a duty to speak is silence actionable. A duty might arise in a few ways:

   1. ITM was buying or selling its own shares.
   2. ITM was aware of insider trading by others.
   3. ITM had a duty to update an earlier statement that had become inaccurate and that was still "alive" in the trading market.
   4. ITM had a fiduciary duty to its shareholders that required disclosure.

   None seems to apply here. There was no trading, and there was no "current" information about electrolysis research that the new tests contradicted. Finally, ITM's decision not to disclose the breakthrough is protected by the business judgment rule. Cf. *Malone v. Brincat*, 722 A.2d 5 (Del. 1998) (imposing a "duty of honesty" whenever corporate managers communicate with shareholders) (see §21.1). ITM's management could decide secrecy is in the corporation's best interests for competitive or any other business-related reason. An evaluation of ITM's disclosure duties turns on general, rather than individual, shareholder wealth maximization.

   b. "No comment." The Supreme Court in *Basic, Inc. v. Levinson* (see §22.3.1) took the view that such a response is tantamount to silence. Absent a duty to speak, silence is not actionable under Rule 10b-5—even when the company has highly material information.

   Although some might view a "no comment" answer to be tacit confirmation of undisclosed material information, the Supreme Court suggests companies can create a reputation for discretion, whether or not there are material developments. The president might well say, "We have a corporate policy not to comment on market trends or rumors."

c. Yes, if the preliminary tests were material. Whenever a company makes a statement about material information, it cannot be false or misleading. ITM's management might argue the press release is essentially true because management thinks the tests have been kept secret and does not know why there has been unusual trading activity. On similar facts, the Supreme Court in *Basic, Inc. v. Levinson* (see §22.3.1) rejected this sophistic argument. A "no developments" statement suggests management does not know of information that would be of interest to the market, which is misleading if the tests are material.

To judge the materiality of the tests requires balancing the probability of an energy-storage breakthrough (which may be low because the tests were preliminary) and the breakthrough's significance to the corporation (which is extremely high). See *Basic, Inc. v. Levinson* (§22.3.1). The "probability plus magnitude" test suggests it is substantially likely that reasonable shareholders would consider the tests relevant to their buy-sell decisions. This conclusion is bolstered if the recent price increases were related to rumors about energy-storage research. They would indicate that energy-storage information is relevant to trading and pricing of ITM's stock.

d. The release should have made clear the tests are preliminary, have not been confirmed, and might never be confirmed:

ITM's research scientists have conducted tests using a cobalt/phosphate film that results in high rates of electrolysis at room temperatures. The tests have not been confirmed by the company or by independent researchers. It is possible that they cannot be duplicated.

The release must walk a fine line. If it is overly pessimistic, some shareholders may sell, be disappointed, and sue. If it is overly optimistic, some investors may buy, be disappointed, and sue.

5. a. Yes. A private purchaser (or seller) of securities has an implied right of action under Rule 10b-5. Further, there is no privity requirement if the challenged misstatements were made "in connection with" stock trading. ITM (even though it never transacted) should have known that shareholders and investors would rely on its press release.

b. Yes, reliance is an element of a 10b-5 action. In a face-to-face transaction, Sharon would have to show that she actually knew of the press release and that she sold because of its bad news. When trading

occurs in an impersonal stock market, courts relax the reliance requirement and accept a "fraud on the market" theory. *Basic, Inc. v. Levinson* (see §22.3.1). Under this theory, a public company's stock price is set by available public information and those who trade rely on the integrity of the market. If there is fraud, the stock price impounds the misinformation and those who trade rely on the misinformation as though they had known of it.

Once Sharon had shown a developed trading market in ITM stock, ITM would have the burden to rebut the presumption of reliance by showing a break between the misinformation and Sharon's trading: (1) ITM's stock is not widely followed and misinformation is not necessarily reflected in its stock price; (2) securities traders already knew of the preliminary tests, the press release notwithstanding; (3) Sharon would have traded even if the price had been different or she had known the press release was false.

c. Probably. Even though Sharon has sued more than two years after her purchase or sale of securities, the statute of limitations for federal securities fraud action permits a 10b-5 action to be brought within two years after "discovery of the facts constituting the violation," so long as the action is brought within five years after the violation. 28 U.S.C. §1658(b). Here the violation occurred when Sharon sold on the basis of the company's false press release. When should she have discovered the press release was false and the company had acted with scienter? See *Merck & Co. v. Reynolds* (see §9.4.1) (interpreting the two-year limitations period of §1658 to accrue either (1) when the plaintiff actually discovers the violation or (2) when a reasonably diligent plaintiff would have discovered the facts constituting the elements of the violation). Although there was much speculation about ITM's electrolysis research, the market seemed not to know for sure until the company's SEC filing, which also would have alerted Sharon to look into whether company officials knew that prior statements had been false. To expect Sharon to be more prescient than the market would seem inconsistent with Congress's purpose in lengthening the statute of limitations to protect defrauded investors against concealment.

CHAPTER 23 Insider Trading

Insider trading has captured the popular imagination. From press accounts, it would seem the most contemptible of corporate behaviors. Remarkably, state corporate law mostly accepts the principle of unfettered share liquidity and only narrowly regulates the trading of company stock by insiders. The real law of insider trading is federal—an offshoot of Rule 10b-5 under the Securities Exchange Act of 1934. See Chapter 22.

This chapter describes the nature of insider trading (§23.1), state corporate law of insider trading (§23.2), the federal "abstain or disclose" duties and enforcement under Rule 10b-5 (§23.3), and new rules on insider trading added by the Sarbanes-Oxley Act of 2002 and revised in the Dodd-Frank Act of 2010 (§23.4). Chapter 24 considers §16 of the Exchange Act—a remedial scheme applicable to short-swing trading profits by designated insiders.

§23.1 Insider Trading—A Primer

§23.1.1 Classic Insider Trading

The paradigm case of insider trading arises when a corporate insider trades (buys or sells) shares of his corporation using material, nonpublic information

obtained through the insider's corporate position. The insider exploits his informational advantage (a corporate asset) at the expense of the corporation's shareholders or others who deal in the corporation's stock.

The insider can exploit his advantage whether undisclosed information is good or bad. If *good news,* the insider can profit by buying stock from shareholders before the price rises on the favorable public disclosure. (An insider can garner an even greater profit on a smaller investment by purchasing "call options" on an options market that give him a right to buy the shares at a fixed price in the future.) If *bad news,* the insider can profit by selling to unknowing investors before the price falls on unfavorable disclosure. (An insider who does not own shares can also profit by borrowing shares and selling them for delivery in a few days when the price falls, known as "selling short," or by purchasing "put options," which give him the right to sell the shares at a fixed price in the future.)

§23.1.2 Misappropriation of Information—Outsider Trading

An insider can also exploit an informational advantage by trading in *other* companies' stock—"outsider trading." If the insider learns that his company will do something that affects the value of another company's stock, trading on this material, nonpublic information can also be profitable. The insider "misappropriates" this information at the expense of his firm. Although he trades with shareholders of the other company, he violates a confidence of his firm.

Many cases reported in the media as "insider trading" are actually cases of outsider trading on misappropriated information. Although classic insider trading and misappropriation often are grouped together under the rubric of "insider trading," it is useful to distinguish the two. The justifications for regulating each differ.

§23.1.3 Theories for Regulating Insider Trading

There are a number of theories for regulating trading by those with material, nonpublic information—whether insiders or outsiders.

Enhance Fairness

Insider trading is unfair to those who trade without access to the same information available to insiders and others “in the know”—a *fairness* rationale. The legislative history of the Exchange Act, for example, is replete with congressional concern about “abuses” in trading by insiders. This fairness notion, however, has not been generally accepted by state corporate law, which has steadfastly refused to infer a duty of candor by corporate insiders to shareholders in anonymous trading markets. See *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933) (rejecting duty of insiders to shareholders except in face-to-face dealings). Moreover, a fiduciary-fairness rationale cannot explain regulation of outsider trading based on misappropriated information.

Preserve Market Integrity

Insider trading undermines the integrity of stock trading markets, making investors leery of putting their money into a market in which they can be exploited—a *market integrity* rationale. A fair and informed securities trading market, essential to raising capital, was the purpose of the Exchange Act. Moreover, market intermediaries (such as stock exchange specialists or over-the-counter market makers) may increase the spread between their bid and ask prices if they fear being victimized by insider traders. Greater spreads increase trading costs and undermine market confidence. Yet a market integrity explanation may overstate the case for insider trading regulation. Many professional participants in the securities markets already trade on superior information; the efficient capital market hypothesis posits that stock prices will reflect this better-informed trading. See §1.2.

Reduce Cost of Capital

Insider trading leads investors to discount the stock prices of companies (individually or generally) where insider trading is permitted, thus making it more expensive for these companies to raise capital—a *cost of capital* rationale. In stock markets outside the United States, studies show that cost of equity decreases when the market introduces and enforces insider trading prohibitions. For this reason, most U.S. public companies have insider trading policies that permit insiders to buy or sell company stock only during “trading windows”—usually 7 to 30 days after important company announcements.

Protect Property Rights

Insider trading exploits confidential information of great value to its holder—a *business property* rationale. Those who trade on confidential information reap profits without paying for their gain and undermine incentives to engage in commercial activities that depend on confidentiality. Although in the information age a property rationale makes sense, theories of liability, enforcement, and private damages have grown in the United States out of the rhetoric of fiduciary fairness and market integrity

§23.1.4 Policing Insider Trading

Insider trading, cloaked as it is in secrecy, is difficult to track down. The stock exchanges have elaborate, much-used surveillance systems to alert officials if trading in a company's stock moves outside of preset ranges. When unusual trading patterns show up or trading occurs before major corporate announcements, exchange officials can ask brokerage firms to turn over records of who traded at any given time. The exchanges conduct computer cross-checks to spot "clusters" of trading—such as from a particular city or brokerage firm. An Automated Search and Match system, with data on thousands of companies and executives on such things as social affiliations and even college ties, assists the exchanges. If the exchanges see something suspicious, they turn the data over to the SEC for a formal investigation. The SEC can subpoena phone records and take depositions, and promise immunity to informants.

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§23.2 STATE LAW ON INSIDER TRADING

In a relatively narrow range of cases, state law limits insiders' liquidity rights when they trade on material, nonpublic corporate information.

§23.2.1 Fraud or Deceit—Limited Tort Liability

The traditional law of deceit applies when

- The insider affirmatively misrepresents a material fact or omits a material fact that makes his statement misleading. (There is a duty to speak only in a relationship of trust and confidence.)
- The insider knows the statement is false or misleading or, under evolving notions, recklessly disregards its truthfulness.
- The other party actually and justifiably relies on the statement.
- The other party is harmed as a result.

Restatement (Second) of Torts, §§525, 526, 537, 538. Absent a duty to speak, the insider can avoid tort liability by remaining silent. In a public corporation, this is easy. For example, a company insider who knows of an impending special dividend can buy stock on an impersonal trading market. Even if subject to a special duty to speak, the absence of privity dissolves any causal link between the insider's purchases and particular shareholders' sales.

Early state courts, on the premise that corporate fiduciaries owe duties to the corporation and not to individual shareholders, regulated insider trading only on a showing of actual deceit. This is *caveat emptor*—the insider has no more duty than a used car salesperson owes her customers.

§23.2.2 State Fiduciary Rules

State corporate law has taken three approaches to insider trading: (1) a duty on insiders not to trade with corporate shareholders in face-to-face transactions while in the possession of highly material, nonpublic corporate information—the "special facts" rule (the majority rule); (2) a duty on insiders not to trade with corporate insiders in face-to-face transactions, regardless of the existence of special facts—the Kansas rule (the minority rule); (3) a duty on insiders *to the corporation* not to advance their own pecuniary position using corporate information, regardless of the harm to the corporation— the rule in New York.

Special Facts Doctrine

The traditional fraud rule fails to recognize an insider's fiduciary status. In recognition of this, state courts impose a diluted duty on individual shareholders to disclose their inside information or abstain from trading. In face-to-face transactions—as distinguished from transactions on stock trading markets between anonymous traders—courts have developed a *special facts*

rule under which neither affirmative misrepresentations nor actual reliance need be established.

The special facts doctrine is limited as follows:

- The insider (an officer or director) must have purchased from an existing shareholder—in some jurisdictions, sales by insiders to nonshareholder investors in the case of "bad news" are not covered.
- The insider must be in privity with the selling shareholder—there must be a face-to-face transaction or something approximating it (such as an insider using an agent to hide the insider's identity).
- The corporate information that the insider knows must be highly material, such as the impending sale of significant corporate assets or the declaration of a special dividend.
- Secrecy is critically important to the sale—it must be clear the shareholder would not have traded had she known the information.

See *Lank v. Steiner*, 224 A.2d 242 (Del. 1966) (when corporate fiduciary buys from or sells directly to existing stockholder, fiduciary must disclose in such private transaction only when fiduciary "possesses special knowledge of future plans from secret sources and deliberately misleads a stockholder who is ignorant of them"). Special facts cases have often involved concealment of the insider's identity and sympathetic plaintiffs, such as widows.

The special facts rule arose in *Strong v. Repide*, 213 U.S. 419 (1909). The Supreme Court, applying general federal common law before *Erie Railroad v. Tompkins,* held a dominant insider could not trade surreptitiously with an unsuspecting shareholder when the insider possessed highly material, confidential corporate information. Repide (the company's majority shareholder and general manager) had finished negotiating the sale of a significant corporate property and sought to buy more corporate shares from a fellow shareholder. To hide his identity, Repide used an intermediary who bought the shares from the shareholder's agent. The Court agreed the agent would not have sold had he known Repide was the buyer. When the contract was finalized, the company's stock value increased tenfold. The Court held that Repide's position, along with his active concealment of highly material information, were "special facts" that supported rescission of the stock sale.

Strict (Kansas) Rule

A handful of state courts have expanded the special facts rule to impose a duty to disclose material nonpublic information in any face-to-face transaction. "Special facts" need not be present. This stricter approach, which originated in a Kansas case, is known as the "Kansas rule." In *Hotchkiss v. Fischer,* 16 P.2d 531 (Kan. 1932), the court said that in direct-negotiated purchases there is a "relation of scrupulous trust and confidence." A corporate president had told a widow, undecided whether to sell her shares or wait for a dividend, that he was unsure whether a dividend would be declared. The president bought the widow's shares for $1.25 per share, and a week later the board declared a $1.00 dividend—a possibility of which the president was aware. The court held the president liable. Although the case's facts fall in the "special facts" mainstream, the "scrupulous trust and confidence" rationale imposes a higher disclose-or-abstain duty. The "Kansas rule" has been rejected in some jurisdictions.

Limitations of Special Facts and Kansas Rules

The special facts and Kansas rules have two significant shortcomings. First, the rules assume purchases from existing shareholders on the basis of undisclosed "good news." A number of courts have refused to impose liability when an insider dumps stock on *nonshareholder investors* using inside "bad news." Second, the rules require privity. When insider trading occurs on an anonymous stock trading market, state courts have shown great reluctance to impose a disclose-or-abstain duty.

Consider *Goodwin v. Agassiz,* 186 N.E. 659 (Mass. 1933), where the court held that insiders who purchased their company's stock on the Boston Stock Exchange could not be held liable under a special facts test. The insiders had access to a geologist's theory that, if valid, indicated the possibility of valuable copper deposits on property owned by the company. The court found two problems with imposing liability. First, the insiders had a fiduciary duty to the corporation, not to individual shareholders. Assuming the insider trading did not harm the company, the insiders were not liable as fiduciaries. Second, privity between buyer and seller does not exist in anonymous trading on a stock exchange. There would be insurmountable practical problems of making disclosure to other traders, deciding when information (such as a geologist's theory) becomes material, and aligning sale and purchase transactions to determine which shareholders are entitled to recover and how much.

§23.2.3 Liability to Corporation

In an attempt to overcome these gaps in the common law, the New York Court of Appeals held more than 30 years ago that insider trading creates liability *to the corporation,* which liability can be enforced in a derivative suit. *Diamond v. Oreamuno,* 248 N.E.2d 910 (N.Y. 1969). The case involved insiders who had dumped their stock after learning nonpublic bad news about the company's earnings. To the objection that the corporation had not been harmed, the court had two responses. First, it held no harm need be shown. As between the insiders and the corporation—just as when an agent receives confidential information on behalf of his principal—the corporation "has a higher claim to the proceeds derived from the exploitation of the information." The insider cannot unjustly enrich himself. Second, the court inferred that the insider trading might have damaged the corporation's reputation and thus the marketability of its stock—though this need not be proved.

The *Diamond v. Oreamuno* court analogized its novel approach to §16(b) of the Exchange Act, which allows the corporation in a direct or derivative suit to recover short-swing trading profits from designated insiders (see §24.3). The court, however, pointed out the inadequacy of federal remedies. In the case, §16(b) offered no relief because trading had occurred outside the provision's six-month window. According to the court, Rule 10b-5 raised unresolved issues on the class entitled to recover, the measure of damages, and the allocation of recovery. (As we will see, these 10b-5 issues are today somewhat clearer. See §23.3 below.)

The *Diamond v. Oreamuno* approach has not fared well outside New York. Some courts have rejected the approach outright. *Schein v. Chasen,* 313 So. 2d 739 (Fla. 1975). Other courts have said that corporate recovery for insider trading requires that the corporation "could have used the information to its own profit." *Freeman v. Decio,* 584 F.2d 186 (7th Cir. 1978). For example, if the corporation was about to repurchase its own stock in the market, insider purchases would directly compete and raise the price to the corporation. See *Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. 1949).

In recent years, the Delaware courts have recognized the ability of shareholders to bring derivative claims on behalf of the corporation (so-called "*Brophy* claims") when an insider uses material, nonpublic information to trade in the company's securities. See *In re Oracle Corp. Deriv. Litig.*, 867

A.2d 904 (Del. Ch. 2004). It is not necessary that the corporation suffered an actual harm; it is enough that the insider was unjustly enriched. The remedy in such cases is disgorgement of the insider's profits to the corporation. See *Kahn v. Kohlberg Kravis Roberts & Co.*, 23 A.3d 831 (Del. 2011) (holding that special litigation committee could not dismiss *Brophy* claim against insider who acquired company's preferred shares while in possession of material, nonpublic information).

Although liability to the corporation offers a practical solution to the limits of the traditional insider trading rules, it has some troubling and strange implications. First, shareholders who hold their shares during the insider trading receive a windfall in a corporate recovery. If the insider trading is on good news, the losers are the shareholders who sold their shares at deflated prices. They do not share in the corporate recovery at all. If the insider trading is on bad news, the losers are the investors who bought the stock at inflated prices. They recover only to the extent the corporate recovery increases the value of their stock—at most a partial recovery. Second, corporate recovery also creates the possibility of double liability. Besides being liable to the corporation, the insiders may be liable under Rule 10b-5 to contemporaneous traders (see §23.3.4). Although the *Diamond v. Oreamuno* court suggested this problem could be handled by interpleader, there will be jurisdictional, notification, and class certification difficulties.

Despite these deficiencies, the ALI Corporate Governance Principles adopted an unjust-enrichment approach similar to *Diamond v. Oreamuno* and the Delaware cases accepting *Brophy* claims, with the additional gloss that the corporation (or the shareholders as a group) can authorize or ratify insider trading if in the corporation's interest. ALI Principles §5.04 (prohibiting insiders from using material nonpublic information concerning the corporation to advance their pecuniary interests, whether or not this use harms the corporation). The ALI Principles views a rule of corporate recovery as better than no rule at all.

Outsider Trading under State Law

You may have noticed that, until now, we have talked only about insiders trading *in their company's shares*—classic insider trading. Very few state cases involve allegations of trading *in other companies' shares* using "misappropriated" information—outsider trading. At most, outsider trading may violate state trade secret laws and the antifraud provisions of state "blue

sky" laws. See §5.1.3.

Examples

1. Elbert, a chemist of ITM Corp., has conducted tests on a cost-effective electrolysis process (separation of water into hydrogen and oxygen) using a cobalt/phosphate film at room temperatures. The results are a huge scientific breakthrough with enormous commercial potential. Daniela, ITM's president, learns of the tests and sends a memo to all who know of them urging complete secrecy. ITM's stock, which is publicly traded, doubles when ITM eventually confirms the tests and discloses the discovery. Assume the following happen before public disclosure:
   a. After Elbert's tests are confirmed, ITM's board offers Daniela options on the company's stock. Daniela accepts the options without telling the board of Elbert's tests. Is Daniela liable to the corporation under state law?
   b. Before Elbert's tests are confirmed, Daniela purchases ITM stock from Columbia Employees Pension Trust, one of ITM's major institutional shareholders. Daniela buys the stock from CEPT using a stockbroker, who does not disclose for whom the purchases are made. Is Daniela liable to CEPT?
   c. Daniela purchases ITM stock through her broker, who fills the order on a stock exchange. Shareholders who sold at about the time of Daniela's purchases seek to recover from her the profits they would have made if they had not sold. Can they under state common law?
   d. Elbert (who is neither a director nor officer of ITM) purchases ITM stock from fellow employees who do not know of the discovery. He says nothing to them, and they do not ask. Is Elbert liable to these shareholders under state common law?
2. Let's turn the tables. Assume ITM publicly announces Elbert's tests before they are confirmed. The price of ITM's stock rises dramatically. Elbert then tells Daniela the announcement was premature. The tests appear to have been a fluke and cannot be reproduced. When ITM issues a public disclaimer, the price of its stock plummets to preannouncement levels. Assume the following happen before ITM disavows the original announcement:
   a. Daniela sells her stock under a corporate stock repurchase program at

current market prices. She does not tell the board or anyone else that the announcement has become misleading. Is Daniela liable to the corporation under state law?

b. Daniela sells her entire shareholding to Mutual of Columbia, a major insurance company, through various brokers who do not disclose for whom they were selling. Is Daniela liable to MOC under state common law?

c. Elbert (who is neither a director nor officer of ITM) buys put options as soon as he realizes the original tests are flukes. Can any of those on the other side of these transactions recover under state common law?

d. Elbert prepares the original announcement about the cobalt/phosphate electrolysis process, knowing that his preliminary tests are flukes. Elbert buys options, as above. Is he liable to the parties on the other side of these transactions under state common law?

Explanations

1. a. Probably, under both state fraud law and common law of insider trading. As the company's CEO, Daniela has a fiduciary duty *to the corporation* not to use her position to harm the corporation. Although she did not misrepresent anything, deceit law imposes a duty to speak on those in a relationship of trust and confidence. Further, her silence in the *face-to-face* negotiations fits the "special facts" test. The discovery had enormous potential value, and it is likely the board would have reconsidered its decision to approve the options.

b. Perhaps under the strict Kansas rule. CEPT probably will be unable to show all the elements of fraud—there were no affirmative misrepresentations and CEPT did not actually rely on Daniela's silence. CEPT did not know it was buying from Daniela and thought it was selling at a good price. Although evolving fraud standards impose a duty to disclose in a confidential relationship—requiring disclosure to an employer or a client—state fraud law has not yet expanded to cover a corporate insider's relationship *to shareholders*.

Both the strict Kansas rule and the more limited "special facts" doctrine cover insiders' trading outside of impersonal trading markets.

Nonetheless, the "materiality" requirements under the tests are different. Under the "special facts" doctrine, Elbert's preliminary tests must have constituted unusual or extraordinary information that, if disclosed, would have caused a reasonable shareholder to have acted differently. This may be hard to show because the tests had to be confirmed, and a reasonable shareholder might have viewed the preliminary tests as flukes. The strict Kansas rule is less deferential. It is enough that the information would have been important to the shareholder's decision to sell. In view of the enormous potential revealed by the preliminary tests, Daniela's duty of "scrupulous trust and confidence" probably would have required her not to trade without first disclosing the tests and their potential implications.

c. No. State fraud law requires some misrepresentation, absent in this case of impersonal market trading. Moreover, identifiable privity is required under the "special facts" doctrine and the strict Kansas rule. The absence of face-to-face dealings will preclude these shareholders from recovering from Daniela. Notice that the *Diamond v. Oreamuno* corporate recovery approach also leaves them in the cold because any recovery goes only to the corporation.

d. No. Although state fraud law prohibits silence by those in a confidential relationship, it is unlikely that Elbert's coworker relationship would be enough. Courts have applied the special facts and strict Kansas rules only to officers and directors. Thus, even though Elbert as an employee has a fiduciary relationship to the corporation, he may not have a corporate fiduciary relationship to fellow coworkers or shareholders under state law.

2. a. Probably. Just as a fiduciary cannot buy from the corporation on the basis of undisclosed "good news," the fiduciary cannot sell to the corporation on the basis of undisclosed "bad news." Elbert's inability to confirm the original tests would seem to be material under both a special facts and Kansas rule.

b. No. There was no affirmative misrepresentation or confidential relationship, and hence no fraud under state law. Further, liability under a special facts or strict Kansas rule is premised on the fiduciary's relationship to existing shareholders. Daniela's sale to a nonshareholder investor leaves MOC unprotected under traditional state law. Even if

corporate recovery were available under a *Diamond v. Oreamuno* theory, ITM's recovery would only indirectly and partially compensate MOC to the extent the recovery increased the value of MOC's shares.

c. Probably not. Under a put option, Elbert receives a contractual right to sell ITM stock to the option sellers in the future at a predetermined price (the *strike price*). If the strike price is higher than the market price on the strike date—which will certainly be the case once the "bad news" is announced—Elbert will profit either by selling cheap stock or (as is more common) by simply having the other party buy back the commitment at the difference between the lower market price and the higher strike price. There are options markets on which these arrangements can be made.

   There are a number of impediments for options sellers to recover. Fraud law requires some affirmative misrepresentation—there was none. Corporate fiduciary rules require that there have been some semblance of privity—there was none. Further, because options traders are not shareholders of the corporation, even *Diamond v. Oreamuno* recovery may be unavailable since the disappointed traders were not past or present shareholders.

d. Yes, under a fraud theory. Fraud law does not require privity; it is enough that Elbert knowingly made an affirmative misrepresentation intending that others rely, that the options sellers actually and justifiably relied, and that they were damaged as a result. Assuming the options sellers knew of the ITM announcement—which is likely—they have a good chance to recover. State corporate law, however, provides little help. None of the options sellers was trading in the capacity of an ITM shareholder.

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§23.3 APPLICATION OF RULE 10B-5 TO INSIDER TRADING

Federal securities regulation of insider trading has developed in stages. It began with the novel scheme in the Exchange Act for the disgorgement of insider trading profits, a scheme aimed at discouraging stock price manipulation by corporate insiders (see Chapter 24). Later in the 1960s the

SEC and federal courts used Rule 10b-5 to build an awkward "abstain or disclose" jurisprudence applicable to insiders who trade on material, nonpublic, confidential information. See *In re Cady, Roberts & Co.*, 40 SEC 907 (1961) (first case suggesting that trading on inside information might violate Rule 10b-5).

In the 1980s Congress entered the fray and increased the penalties for insider trading, clarified the scope and mechanisms for private enforcement, and imposed additional surveillance duties on firms with access to inside information. In 2000 the SEC promulgated rules clarifying the state of mind that triggers liability and the persons who become subject to the "abstain or disclose" duty. In 2002 Congress sought to discourage insider trading by executives that came at the expense of employees or was based on falsified company financials. In 2010 Congress strengthened corporate "clawback" devices to discourage corporate executives from manipulating company financials to increase their stock-based pay.

The development of 10b-5 insider trading duties is a fascinating story of judicial activism and ingenuity in the face of a statutory lacuna. It also offers an insight into the operation of corporate federalism. Perceiving a failure by state corporate law to regulate insider trading, federal courts have used Rule 10b-5 to develop a theory of disclosure-based regulation that assumes the existence of fiduciary duties of confidentiality that state courts have been unwilling to infer.

§23.3.1 Federal Duty to "Abstain or Disclose"

Federal courts have interpreted Rule 10b-5 to prohibit securities fraud. See §22.1. No person may misrepresent material facts that are likely to affect others' trading decisions. This duty is meaningless to insider trading, which happens not by means of misrepresentations but rather silence. Over time, federal courts have developed rules against insider trading based on implied fiduciary duties of confidentiality.

Parity of Information

Early federal courts held that just as every securities trader is duty-bound not to lie about material facts, anyone "in possession of material, nonpublic information" must either abstain from trading or disclose to the investing public—a duty to *abstain* or *disclose.* See *SEC v. Texas Gulf Sulphur,* 401

F.2d 833 (2d Cir. 1968). But even the proponents of a "parity of information" (or "equal access") approach recognized that an absolute rule against trading when one has an informational advantage goes too far. Strategic silence is different from outright lying. To impose an abstain-or-disclose duty on everyone with material, nonpublic information—however obtained—would significantly dampen the enthusiasm for trading in the stock market. Capital formation might dry up if investors in trading markets were prohibited from exploiting their hard work, superior skill, acumen, or even their hunches. Investors would have little incentive to buy securities if they could not resell them using perceived informational advantages.

Fiduciary Duty of Confidentiality

In the early 1980s the Supreme Court provided a framework for the abstain-or-disclose duty. *Chiarella v. United States,* 445 U.S. 222 (1980); *Dirks v. SEC,* 463 U.S. 646 (1983). A decade later the Court brought "outsider trading" within this framework. *United States v. O'Hagan,* 521 U.S. 642 (1997). Reading Rule 10b-5 as an antifraud rule, the Court has held that any person in the possession of material, nonpublic information has a duty to disclose the information, or abstain from trading, if the person obtains the information in a relation of trust and confidence—a fiduciary relation. The Supreme Court thus anchors federal regulation of classic insider trading on a presumed fiduciary duty of corporate insiders to the corporation's shareholders—even though state corporate law has largely refused to infer such a duty in impersonal trading markets. See §23.2.2. Thus, the federal regulation of insider trading began largely as a judicial invention! The Court has extended this fiduciary-based regulation to cover trading by outsiders who breach fiduciary duty of confidentiality to persons or entities unrelated to the corporation in whose securities they trade.

Classic insider trading liability: Chiarella v. United States *(1980)*

Chiarella was employed in the composing room of a financial printer. Using his access to confidential takeover documents that his firm printed for corporate raiders, he figured out the identity of certain takeover targets. Chiarella then bought stock in the targets, contrary to explicit advisories by his employer. He later sold at a profit when the raiders announced their bids. The Supreme Court reversed Chiarella's criminal conviction under Rule 10b-5 and held that Rule 10b-5 did not impose a "parity of information"

requirement. Merely trading on the basis of nonpublic material information, the Court held, could not trigger a duty to disclose or abstain. Chiarella had no duty to the shareholders with whom he traded because he had no fiduciary relationship to the *target companies or their shareholders.* (The Court decided that Chiarella could not be convicted for trading on information misappropriated from his employer since the theory was not presented to the jury.)

Tipper-tippee liability: **Dirks v. SEC** *(1983)*

Dirks was a securities analyst whose job was to follow the insurance industry. When he learned of an insurance company's massive fraud and imminent financial collapse from Secrist, a former company insider, Dirks passed on the information to his firm's clients. They dumped their holdings before the scandal became public. On appeal from SEC disciplinary sanctions for Dirks's tipping of confidential information, the Supreme Court held that Dirks did not violate Rule 10b-5 because Secrist's reasons for revealing the scandal to Dirks were not to obtain an advantage for himself. For Secrist to have tipped improperly "in connection with" the trading by Dirks's clients, the Court held, there had to have been a fiduciary breach. The Court took the view that a breach occurs when the insider gains some direct or indirect personal gain or a reputational benefit that can be cashed in later. In the case, Secrist had exposed the fraud with no expectation of personal benefit, and Dirks (whose liability depended on Secrist violating a fiduciary duty) could not be liable for passing on the information to his firm's clients.

Misappropriation liability: **United States v. O'Hagan** *(1997)*

O'Hagan was a partner in a law firm retained by a company planning to make a tender offer for a target company. He purchased common stock and call options on the target's stock before the bid. Both the bidder and law firm had taken precautions to protect the bid's secrecy. When the bid was announced, O'Hagan sold for a profit of more than $4.3 million. After an SEC investigation, the Justice Department brought an indictment against O'Hagan alleging securities fraud, mail fraud, and money laundering. He was convicted on all counts and sentenced to prison. The Eighth Circuit, however, reversed his conviction on the ground that misappropriation did not violate Rule 10b-5. (The Eighth Circuit also held the SEC exceeded its authority in promulgating Rule 14e-3. See §23.3.3 below.) The Supreme Court reversed

and validated the misappropriation theory. The Court concluded that the unauthorized use of confidential information is (1) the use of a "deceptive device" under §10(b) and (2) "in connection with" securities trading. First, the misappropriator "deceives" the source that entrusted to him the material, nonpublic information by not disclosing his evil intentions—a violation of fiduciary duty. Second, the "fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when … he uses the information to purchase or sell securities." Citing to the legislative history of the Exchange Act and to SEC releases, the Court concluded that misappropriation liability would "insure the maintenance of fair and honest markets [and] thereby promote investor confidence." O'Hagan's trading operated as a *fraud on the source* in connection with securities trading—a violation of Rule 10b-5.

Satisfying the Disclosure Duty

According to the logic of the 10b-5 "abstain or disclose" construct, a fiduciary may trade on confidential information by first disclosing the information to the person to whom she owes the fiduciary duty. See *SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968) (suggesting that insiders wait 24 to 48 hours after information is publicly disclosed to give it time to be disseminated through wire services or publication in the financial press). In a similar vein, some companies have internal policies that permit corporate insiders to trade only during a one- or two-week period after the company files quarterly and annual reports. As a practical matter, the abstain-or-disclose duty is really a prohibition against trading, since any disclosure must be effective in eliminating any informational advantage to the person who has material, nonpublic information—thus eliminating any incentive to trade.

State of Mind

An unsettled issue in the cases has been the state of mind that triggers insider trading liability when a person purchases or sells securities. In *O'Hagan* the Supreme Court said that insider trading must be "on the basis" of material, nonpublic information. Lower courts split on whether the trader must be in "knowing possession" of inside information or must actually consciously "use" the information in trading. Compare *United States v. Teicher,* 987 F.2d 112 (2d Cir. 1993) (accepting "knowing possession" standard, as simpler to apply and consistent with the expansive nature of Rule 10b-5, where a young

attorney tipped inside information about transactions involving clients of his law firm); *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998) (requiring showing of "use" of inside information, particularly when a defendant's state of mind is at issue in criminal case).

In 2000 the SEC adopted a rule to clarify this aspect of insider trading liability. Rule 10b5-1. Under the rule, a person trades "on the basis" of material, nonpublic information if the trader is "aware" of the information when making the purchase or sale. Rule 10b5-1(b). In its release accompanying the rule, the SEC explained that "aware" is a commonly used English word, implying "conscious knowledge," with clearer meaning than "knowing possession." Does the SEC have rulemaking authority to define the elements of insider trading, which (until now) has been governed exclusively by judge-made rules? Arguably the agency that begot Rule 10b-5 can also change and define its contours.

Preexisting Trading Plans

The SEC has also sought to clarify when corporate insiders and others can trade in company stock even when aware of inside information. Individuals and entities who set up specific securities trading plans when unaware of inside information can avoid liability even if trading under the plan occurs later when they are aware of inside information. Rule 10b5-1(c). The person must demonstrate the following:

- She had entered in "good faith" into a binding contract to trade the security, instructed another person to execute the trade for her account, or adopted a written plan for trading securities—when unaware of inside information.
- This preexisting trading strategy either (1) expressly specified the amount, price, and date of the trade; (2) included a written formula for determining these inputs; or (3) disabled the person from influencing the trades, providing the actual trader was unaware of the inside information.
- The trade accorded with this preexisting strategy.

An entity (nonindividual) has an additional affirmative defense if the actual individual trading for the entity was unaware of inside information and the

entity had policies and procedures to ensure its individual traders would not violate insider trading laws. Rule 10b5-1(c)(2).

In 2009 the SEC provided some interpretive guidance when Rule 10b5-2 plans are revised. First, although termination of a trading plan does not automatically trigger 10b-5 liability, a termination that "coincides" with insider trading may violate Rule 10b-5. Second, canceling and then replacing an existing plan may also run into problems if the actions are part of a "scheme to evade" the rule; such liability can be minimized with a "waiting period" between the cancellation and replacement.

§23.3.2 Insider Trading 10b-5 Primer

The linchpin of 10b-5 insider trading liability is the knowing misuse of material, nonpublic information entrusted to a person with duties of confidentiality. Attempting to provide a general definition, the SEC's Rule 10b5-1 offers a restatement of federal insider trading law:

> The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material, nonpublic information about that security or issuer, in breach of a duty of trust and confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material, nonpublic information.

Although the Supreme Court has glossed over the provenance of these duties, its opinions give clear guidance to persons who have material, nonpublic information:

Insiders	Insiders who obtain material, nonpublic information because of their corporate position — directors, officers, employees, and controlling shareholders — have the clearest 10b-5 duty not to trade in the securities of their company. See *Chiarella.*
Constructive (temporary) insiders	Constructive insiders who are retained temporarily by the company in whose securities they trade — such as accountants, lawyers, and investment bankers — are viewed as having the same 10b-5 duties as corporate insiders. See *Dirks* (dictum). Lower courts have also inferred status as constructive insider in family settings where there are expectations of confidentiality.
Outsiders (with duty to source of information)	Outsiders with no relationship to the company in whose securities they trade also have an abstain-or-disclose duty when aware of material, nonpublic information obtained in a relationship or trust and confidence with the company (or source) of that information. See *O'Hagan.* The outsider's breach of confidence to the information source is deemed a deception that occurs "in connection with" his securities trading. *(continued)*

Tippers	Those with a confidentiality duty — whether an insider or an outsider — who knowingly make improper tips are liable as participants in illegal insider trading. See *Dirks*. The tip is improper if the tipper expects the tippee will trade and anticipates reciprocal benefits — such as when she sells the tip, gives it to family or friends, or expects the tippee to return the favor. This liability extends to subtippers who know (or should know) a tip is confidential and came from someone who tipped improperly. The tipper or subtipper can be held liable even though she does not trade, so long as a tippee or subtippee down the line eventually does.
Tippees	Those without a confidentiality duty inherit a 10b-5 abstain-or-disclose duty if they knowingly trade on improper tips. *Dirks*. A tippee is liable for trading after obtaining material, nonpublic information that he knows (or has reason to know) came from a person who breached a confidentiality duty — whether an insider or an outsider. In addition, subtippees tipped by a tippee assume a duty not to trade if they know (or should know) the information came from a breach of duty.
Traders in derivative securities	The 10b-5 duty extends to trading with nonshareholders — such as options traders. *O'Hagan* (call options). The Insider Trading Sanctions Act of 1984 makes it unlawful to trade in any derivative instruments while in possession of material, nonpublic information if trading in the underlying securities is illegal. Exchange Act §20(d).
Strangers	A stranger with no relationship to the source of material, nonpublic information — whether from an insider or outsider — has no 10b-5 duty to disclose or abstain. *Chiarella*. Strangers who overhear the information or develop it on their own have no 10b-5 duties.

It is important to notice that corporate insiders (directors, officers, employees, and agents) often own stock in their companies. This is not illegal — in fact, it is sometimes highly desirable for corporate executives to have some “skin in the game.” Nor is it illegal for these insiders to buy and sell their company stock. There is a problem only when these insiders are aware of nonpublic, material information when they trade in their company’s stock or the stock of another company—or improperly tip this information to others.

§23.3.3 Outsider Trading—Misappropriation Theory

The misappropriation theory is a bit tricky. Under the theory, 10b-5 liability arises when a person trades on confidential information in breach of a *duty owed to the source of the information*, even if the source is a complete

stranger to the traded securities. *United States v. O'Hagan*, 521 U.S. 642 (1997). In effect, the deception is on the source and the trading with another party. This "fraud on the source" construct raises a number of issues: the basis for misappropriation liability, the scope of the duty of confidentiality, and the validity of the SEC's rule creating misappropriation liability for tender offer information.

Notice the difference between an *outsider* who misappropriates information from a source unrelated to the company in whose securities the outsider trades and a *tippee* who receives information from a fiduciary inside a company in whose securities the tippee (or subtippee) trades. The outsider's duty is to the "outside" source of the information; the tippee's duty is derived from the duty to the "insider" who tips improperly.

Misappropriation Theory

The *O'Hagan* decision was an important victory for the SEC, which ten years before had failed to convince the Supreme Court that Rule 10b-5 encompasses a misappropriation theory. *Carpenter v. United States*, 484 U.S. 19 (1987) (split 4-4 decision).

Although the ruling in *O'Hagan* removed any uncertainty about whether Rule 10b-5 regulates securities trading using misappropriated information, it exposed doctrinal rifts in the Court's 10b-5 jurisprudence. First, *O'Hagan* suggests that there can be no 10b-5 insider trading liability if there is no breach of trust and confidence. Thus, a person who gains access to material, nonpublic information by other wrongful means—such as outright theft—would seemingly not face 10b-5 sanctions. Moreover, a fiduciary who discloses his trading intentions or receives permission to trade from the information source would escape 10b-5 liability since there would arguably be no breach of his abstain-or-disclose duty. Cf. *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006) (upholding misappropriation claim against wife who "tricked" husband into revealing confidential company information and then tipped her brother who traded on the information, even though husband asked wife not to tip when she revealed her plans).

Second, *O'Hagan* leaves largely unanswered the question of who has duties of trust and confidence and when a duty of confidentiality attaches. For lawyer O'Hagan, it was easy to identify his duties to his law firm and thus to the bidder, but the inquiry becomes more difficult when a person overhears a conversation or has only a superficial relationship with the information

source. See *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984) (holding that eavesdropper is not liable for trading after overhearing CEO tell his wife company might be liquidated). Nonetheless, when information has been obtained deceptively, the breach of duty is not "cleansed" by later revealing to the source an intention to trade on the deceptively obtained information. See *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006) (holding that wife who deceptively obtained information from her CEO husband was liable for tipping this information to her brother, even though she informed husband of tip).

Duty of Confidentiality in Misappropriation Cases

The duty of trust and confidence in misappropriation cases is clearest when confidential information is misappropriated in breach of an established business relationship, such as investment banker—client or employer-employee. The duty is less clear in other business and personal settings.

In an attempt to provide clarity, the SEC promulgated a rule that specifies—for purposes of misappropriation liability—when a recipient of material, nonpublic information is deemed to owe a duty of trust and confidence to the source for purposes of misappropriation liability. Rule 10b5-2(b):

- The recipient agreed to maintain the information in confidence.
- The persons involved in the communication have a history, pattern, or practice of sharing confidences (both business and nonbusiness confidences) so the recipient had reason to know the communicator expected the recipient to maintain the information's confidentiality.
- The communicator of the information was a spouse, parent, child, or sibling of the recipient, unless the recipient could show (based on the facts and circumstances of that family relationship) that there was no reasonable expectation of confidentiality.

Confidentiality Expectations outside the Family

By their terms, the rule's first two categories clarify when confidentiality expectations—and thus a duty of trust or confidence—arise in nonbusiness and business settings outside the family. Thus, a contractual relationship (though not necessarily creating a fiduciary relationship) could give rise to a duty not to use confidential information, if that is what the parties had agreed

to or mutually understood. In addition, as the SEC stated in its preliminary note to the rule, the list is not exclusive, and a relationship of trust and confidence among family members or others can be established in other ways, as well.

Are confidentiality expectations, without a legal relationship of trust and confidence, enough to trigger a 10b-5 duty to "disclose or abstain"? That is, did the SEC overstep its rulemaking authority in Rule 10b5-2 by identifying duties of "trust and confidence" in the absence of a fiduciary relationship? Consider the SEC's case against Mark Cuban, of Audionet and Dallas Mavericks fame. In 2004 Cuban had a phone conversation with the CEO of Mamma.com, a company in which Cuban was a 6.3 percent shareholder. The Mamma CEO told Cuban confidentially that Mamma was planning to accept a new investor and thus dilute existing shareholders. According to the SEC, Cuban said to the CEO he would keep the information confidential, but then he sold his Mamma shares and avoided losses of $750,000 in the process. When the SEC brought an insider case against him, Cuban argued that his relationship with the Mamma CEO and any confidentiality promise he made did not create a cognizable §10(b) duty. The trial court disagreed with Cuban, but dismissed the SEC's case on the theory that Cuban's oral promise of confidentiality encompassed only keeping the information confidential, but did not bar trading. On appeal, the Fifth Circuit did not address the lower court's novel parsing of the parties' understanding, but instead held that the SEC's complaint laid out a "more than a plausible" case of insider trading, and remanded for further proceedings. *SEC v. Cuban*, 634 F. Supp.2d 713 (N.D. Tex. 2009), *vacated and remanded,* 620 F.3d 551 (5th Cir. 2010). At trial, the jury found that Cuban had not entered into a confidentiality agreement and, in any event, the information about Mamma's new investor was already public knowledge, given an earlier spike in trading volume in the company's stock. The SEC licked its wounds and said it would continue to bring cases where it believed there had been insider trading. As for the Mavericks, there's always next season!

Confidentiality Expectations inside the Family

Rule 10b5-2 was adopted largely in response to the anomaly in the case law that a family member who trades on material, nonpublic information obtained from a another family member violates Rule 10b-5 if the trading breached an *express promise* of confidentiality, even when there was a

reasonable expectation of confidentiality. The SEC rule treats insider trading by family members on the basis of inside information as undermining market and investor confidence, whether the expectation of confidentiality was express or implied. As the SEC explained, the trader's informational advantage in either case stems from "contrivance, not luck." Additionally, the SEC said its brighter-line approach was less intrusive than a case-by-case analysis into the nature of family relationships, as required by existing case law. See *United States v. Chestman*, 947 F.2d 551 (2d Cir.1991) (en banc) (holding that son-in-law owed no duty to in-laws who planned to sell their supermarket chain, when he and his broker traded on confidential information about impending sale).

Some courts have used this "expectation" analysis in cases of classic insider trading on the question whether family members qualify as "constructive insiders." In *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003), a husband told his wife during divorce discussions that his stock options should be re-valued at a lower price because of a soon-to-be-made announcement of a drop in company earnings. The wife then told office mates about this impending news, who traded on the tip. The court held that spousal communications implicated a fiduciary duty when the communicating spouse has a "reasonable expectation of confidentiality"—given their history or practice of sharing business confidences. The court commented that Rule 10b5-2, which creates a presumption of spousal confidentiality in misappropriation cases, bolstered the conclusion that spouses should be understood to have expectations of confidentiality in cases of classic insider trading.

Confidentiality Expectations in Congress

Do members of Congress and their staff have duties of trust or confidence to the American public? Until 2012, the question was open. But in that year, Congress passed the Stop Trading on Congressional Knowledge (STOCK) Act to extend insider-trading restrictions to members of Congress and legislative employees by specifying that such persons owe duties to the United States (as well as Congress and U.S. citizens) with respect to material nonpublic information derived from their position or gained from performing their official responsibilities. See Exchange Act §21A(g). Thus, members of Congress and their aides—as well as any recipients who trade on congressionally sourced information—can be liable for insider trading under

Rule 10b-5.

Before the STOCK Act, there were doubts about whether members of Congress and their aides were subject to duties not to engage in stock trading on the basis of confidential information gleaned through their public service. Nonetheless, the Act does not resolve how regulators will enforce the prohibition—given the evidentiary barriers created by the Constitution's "Speech or Debate" clause that immunizes lawmakers in their official legislative activities. Nor does the STOCK Act prevent members of Congress and their aides from owning company stock in industries that they have the power to impact.

But just as corporate insiders must report their trading in their corporation's stock (see §24.2 below), members of Congress and their aides must report their stock trades above $1,000 within 30 to 45 days of the trade. See Ethics in Government Act of 1978 §103 (along with other specified members of executive and judicial branches). Not only does such reporting allow the public to compare congressional stock trading with congressional activities, it also can serve as the basis for public and private insider-trading actions.

In particular, the STOCK Act affects Wall Street "data miners" that gather political intelligence from congressional sources to predict legislative outcomes that might affect stock prices. These firms, as well as law firms and lobbyists, now face "tippee" liability for passing on nonpublic congressional information that they received in breach of the source's duties. Although members of Congress may have immunity, private parties that trade on illegally tipped congressional information do not.

Tipping of Misappropriated Information

Just as it is illegal to trade on a tip from an insider, it is illegal to trade on a tip from an outsider who passes misappropriated information to obtain a personal benefit. That is, 10b-5 tipping liability described in *Dirks* applies to tips both from insiders and from outsiders. See *United States v. Falcone*, 257 F.3d 226 (2d. Cir. 2001) (finding 10b-5 liability when distributor of *Business Week*, before magazine went on sale to general public, passed on copies to neighbor/broker who traded on nonpublic information in magazine).

Consider a recent case involving tipped misappropriated information. One Strickland, a financial analyst at GE Capital, learned that a client, Allied Capital, was planning to acquire SunSource. Strickland mentioned this to one

Black (a former college roommate) who then “to curry favor” told his boss, one Obus at Wynnefield Capital. Obus had Wynnefield buy 50,000 shares of SunSource—resulting in a $1.3 million profit. The SEC sued Strickland (as tipper), Black (as tippee and sub-tipper) and Obus (as sub-tippee). The Second Circuit agreed that there was sufficient evidence that Strickland breached a duty to his employer, GE Capital, by tipping Black, knowing that the information was confidential. The court held Black could be liable for tipping the information because he knew it was confidential and his “close friendship” with Strickland constituted a sufficient personal benefit. And Obus could be liable for “consciously avoiding” any further inquiry in the face of a “credible” tip. *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012) (finding evidence sufficient to overcome defendants’ motions for summary judgment).

The case has created a stir. First, the court’s conclusion that Strickland may have committed a fiduciary breach was contradicted by an internal GE Capital investigation that concluded he had not—rendering “waiver” of duty by the source insufficient to avoid tipping liability. Second, the court concluded that “personal benefit” could be as ephemeral as the *quid pro quo* of a personal friendship—almost gutting the element. Third, the court accepted that a sophisticated sub-tippee could not easily claim ignorance about the tip’s source under the “know or should know” element of the *Dirks* test—making circumstantial evidence sufficient to show a sub-tippee should have known of a tip’s tainted origin.

Rule 14e-3—Misappropriation of Tender Offer Information

The SEC has used the misappropriation theory to adopt rules prohibiting trading based on material, nonpublic information about *unannounced tender offers*. Using its rulemaking authority under §14(e) of the Exchange Act—which allows rules aimed at “fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer”—the SEC prohibited trading by those with inside information about a tender offer. Exchange Act Rule 14e-3. The rule prohibits, during the course of a tender offer, trading by anybody (other than the bidder) who has material, nonpublic information about the offer that he knows (or has reason to know) was obtained from either the bidder or the target. Notice that there is no need under Rule 14e-3 to prove that a tipper breached a fiduciary duty for personal benefit. See *United States v. O’Hagan*, 521 U.S. 642 (1997) (upholding SEC’s rulemaking authority to “define and prescribe means reasonably designed to

prevent [fraudulent] acts” under §14(e) of the Exchange Act).

The Second Circuit has considered the difference between 10b-5 and 14e-3 liability. *United States v. Chestman,* 947 F.2d 551 (2d Cir. 1991) (en banc). In the case Chestman, a stock broker, learned of an impending tender offer from the husband of the niece of the company’s controlling shareholder. The controlling shareholder had agreed to sell his control block as a prelude to the purchaser’s tender offer. When Chestman traded on this information for himself and his clients, the government prosecuted him under Rules 10b-5 and 14e-3. The Second Circuit affirmed Chestman’s 14e-3 conviction, for which no showing of duty was necessary. But the court held he could not be convicted under a 10b-5 misappropriation theory because the family tipper had no duty to his family to guard confidential information.

Mail and Wire Fraud—Criminal Liability for Misappropriation

Misappropriation of confidential information can also be the basis of nonsecurities criminal liability. In *Carpenter v. United States,* 484 U.S. 19 (1987), the Supreme Court had sidestepped the 10b-5 quagmire by affirming in an 8-0 decision a *Wall Street Journal* reporter’s conviction under federal mail and wire fraud criminal statutes for misappropriating and tipping information before it appeared in a column he wrote. (The SEC cannot enforce the mail and wire fraud statutes, which can only be enforced by the Justice Department in a criminal prosecution.) The Court held that the newspaper had a “property” interest in keeping the column confidential prior to publication, and that the reporter’s breach of his confidentiality obligation defrauded the newspaper. Although the Court’s decision raises disquieting issues about criminal liability for breaching an employment stipulation, the case makes clear that trading on misappropriated securities-related information is subject to criminal penalties.

§23.3.4 Remedies for Insider Trading

Insider traders are subject to an imposing host of sanctions and liabilities. As the following list makes clear, it is no wonder that law firms tell new lawyers not to trade on clients’ confidential information.

Civil Liability to Contemporaneous Traders

In an impersonal trading market, it is unclear who is hurt by insider trading and how much. Shareholders and investors who trade at the same time as an insider presumably would have traded even had the insider fulfilled his duty and abstained. If, however, the theory is that insider trading is unfair to traders, recovery should be equal to the traders' contemporaneous trading "losses"—typically significantly greater than the insider's gains. If the theory is that insider trading undermines the integrity of trading markets, recovery should be disgorgement of the insider's trading gains to the market as a whole. If the theory is that those who engage in insider trading pilfer valuable commercial information, recovery should be based on the losses to the owner of the confidential information.

Congress has addressed the issue and adopted a recovery scheme that borrows from both the unfairness and disgorgement rationales. The Insider Trading and Securities Fraud Enforcement Act of 1988 limits recovery to traders (shareholders or investors) whose trades were contemporaneous with the insider's. Recovery is based on the disgorgement of the insider's actual profits realized or losses avoided, reduced by any disgorgement obtained by the SEC under its broad authority to seek injunctive relief (see below). Exchange Act §20A.

Civil Recovery by "Defrauded" Source of Confidential Information

Owners of confidential information who purchase or sell securities can bring a private action under Rule 10b-5 against insider traders and tippees who adversely affect their trading prices. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (actual purchaser or seller standing requirement). A "defrauded" company may recover if it suffered trading losses or was forced to pay a higher price in a transaction because the insiders' trading artificially raised the stock price. *FMC Corp. v. Boesky*, 673 F.2d 272 (N.D. Ill. 1987), *remanded*, 852 F.2d 981 (7th Cir. 1988) (holding tippee not liable for trading on misappropriated information concerning company's impending recapitalization plan because company lost nothing in the recapitalization). Although some commentators proposed corporate recovery *on behalf of shareholders*, courts have insisted on a corporate (not shareholder) injury for there to be corporate recovery.

SEC Enforcement Action

The SEC can bring a judicial enforcement action seeking a court order that enjoins the inside trader or tippee from further insider trading (if likely to recur) and that compels the disgorgement of any trading profits. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (ordering establishment of fund from which shareholders and other contemporaneous traders could recover from insider traders and tippers).

Civil Penalties

To add deterrence, the SEC can also seek a judicially imposed civil penalty against those who violate Rule 10b-5 or Rule 14e-3 of up to three times the profits realized (or losses avoided) by their insider trading. Exchange Act §21A (added by the Insider Trading Sanctions Act of 1984). For example, in 2006, Martha Stewart was ordered to pay $195,000, or three times the trading losses she avoided, for her insider trading of ImClone stock. The penalty, paid into the federal treasury, is in addition to other remedies. Thus, it is possible for an insider or tippee to disgorge her profits (in a private or SEC action) *and* pay the treble-damage penalty.

"Watchdog Penalties"

To create even more deterrence, the SEC can seek civil penalties against employers and others who "control" insider traders and tippers. Exchange Act §21A (added by Insider Trading and Securities Fraud Enforcement Act of 1988). Controlling persons are subject to additional penalties up to $1 million or three times the insider's profits (whichever is greater) if the controlling person knowingly or recklessly disregards the likelihood of insider trading by persons under its control. Broker-dealers that fail to maintain procedures protecting against such abuses may also be subject to these penalties if their laxity substantially contributed to the insider trading.

"Bounty Rewards"

To encourage informants, the SEC can pay bounties to anyone who provides information leading to civil penalties. The bounty can be up to 10 percent of the civil penalty collected. Exchange Act §21A(e) (added by Insider Trading and Securities Fraud Enforcement Act of 1988). This bounty program is in addition to the "whistleblower" bounty program created by Dodd-Frank. See Exchange Act §21F (see §12.3.5).

Criminal Sanctions

To punish those who engage in "willful" insider trading—that is, insider trading where the defendant knows that it is wrongful—the SEC can (and often does) refer cases to the U.S. Department of Justice for criminal prosecution. Exchange Act §32(a). Congress has twice increased the criminal penalties for violations of the Exchange Act and its rules. In the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress increased the maximum criminal fines from $100,000 to $1,000,000 ($2,500,000 for nonindividuals) and jail sentences from five years to ten years. Then in the Sarbanes-Oxley Act of 2002, Congress upped the maximum fines to $5,000,000 ($25,000,000 for nonindividuals) and jail sentences to 20 years. Sarbanes-Oxley §1106, Exchange Act §32(a).

The Exchange Act's criminal provisions provide a curious defense against incarceration for violating an SEC rule if the defendant "proves he had no knowledge of such rule." Exchange Act §32(a). Courts have denied the defense if the defendant recognized he was engaged in deception.

§23.3.5 Regulation FD and Selective Disclosure

Inside information does not stay bottled up in companies forever. Sooner or later, companies communicate to securities markets. Formal disclosure in SEC filings is the soul of federal securities regulation. Informal disclosure, particularly by means of selective discussions with securities analysts and large investors, has been controversial—criticized as systematic tipping of valuable inside information and praised as an efficient way to reveal information to securities markets.

In 2000 the SEC took to heart the criticisms and adopted Regulation FD (Fair Disclosure) to forbid public companies from selectively disclosing material, nonpublic information. Exchange Act Rel. No. 43,154 (2000). The detailed rules on how companies may respond to analyst inquiries and engage in investor relations have altered how company information reaches securities markets. Disclosure practices once widespread, such as giving detailed financial projections to selected securities analysts or reviewing analyst reports before public release, are now regulated.

Regulation FD applies to issuer disclosures of material, nonpublic information to specified market professionals, as well as security holders who

it is "reasonably foreseeable" will trade on the basis of the information. Rule 100(b)(1). When the disclosure is "intentional," issuers must disclose inside information to the investing public *simultaneously* with any disclosure to selected analysts or investors. Rule 100(a)(1). If the issuer discovers it has made an "unintentional" selective disclosure, the issuer must disclose the information to the public *promptly* (generally within 24 hours). Rule 100(a)(2). The information must be disseminated by methods "reasonably designed to achieve broad non-exclusionary distribution to the public"—such as through Internet postings or simulcasts, or by furnishing a Form 8-K to the SEC. Rule 101(e) (defining "public disclosure"). The restrictions apply to the issuer's senior officials and those who regularly communicate with analysts and investors, such as investor relations or public relations officers. Rule 101(f).

The "equal access" rules of Regulation FD have some important exclusions [Rule 100(b)]:

Context	Disclosure Allowed
Normal course of business	Disclosure may be made in the normal course of business, such as to professional advisers (attorneys, investment bankers, or accountants) or business partners in contract negotiations. Dodd-Frank calls on the SEC to eliminate the exclusion for credit rating agencies, unless the credit rating agency receives the information pursuant to a confidentiality or nondisclosure agreement. Dodd-Frank §939B.
Public disclosures	Disclosure may be made to media or government officials, such as by responding to newspaper inquiries or complying with regulatory investigations.
Public offerings	Disclosures may be made in securities offerings registered under the Securities Act, such as to analysts and institutional investors in going-public "road shows."
Foreign private issuers	Disclosure may be made by foreign private issuers (which, if they meet the jurisdictional requirements, remain subject to the securities antifraud provisions).

To take some of the sting out of these rules, Regulation FD is enforceable only through SEC enforcement actions and does not give rise to 10b-5 liability or private enforcement. Rule 102.

Regulation FD is an important step toward a systematic regulation of

inside information. Rather than dealing with each selective disclosure as a possible instance of "tipping," the regime encourages wide dissemination of information—whenever the issuer decides to disclose. The rules encourage the release of information, not its suppression—consistent with the philosophy of securities regulation that all investors have access to the same company-provided information at the same time. The rules also avoid the potential conflicts that analysts once felt to report favorably on companies to protect the flow of selective disclosures and that company executives felt to delay public disclosure so as to curry favor with preferred analysts or institutional investors.

In 2002 the SEC brought its first enforcement actions under Regulation FD. In one case, a company CFO called a handful of analysts to explain that their reports had failed to note that company earnings usually were higher in the second half of the year. The SEC issued an administrative cease-and-desist order, pointing out the company should have publicly disclosed the seasonality of its earnings before calling the analysts. When the company balked and the agency brought a judicial enforcement action, however, the court concluded that the CFO's statements had already been disclosed (or were available) to the public, in the process chiding the SEC for being too linguistic and for chilling company disclosures. *SEC v. Seibel Systems*, 384 F.Supp.2d 694 (SDNY 2005). The court, however, did not address the fact that investors privy to the CFO's statements bought the company's shares, causing the stock price to surge. In short, the market's reaction to the private information suggested its materiality, even though the court's parsing of words led to a different conclusion.

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§23.4 REGULATION OF INSIDER TRADING UNDER SARBANES-OXLEY (AND DODD-FRANK)

In response to the corporate scandals of the early 2000s, the Sarbanes-Oxley Act of 2002 regulates insider trading by company executives in two new situations: during pension fund blackouts and during the year before financials are restated. The Dodd-Frank Act of 2010 adds new "clawback" requirements for public companies.

§23.4.1 Insider Trading during Pension Plan Trading Blackout

Sarbanes-Oxley seeks to prevent insiders from “abandoning a sinking ship” while other employees are prevented from selling their stock. Sarbanes-Oxley §306(a). Directors and officers are prohibited from trading in their company’s stock during any “trading blackout” in the company’s pension plan—that is, when for more than three consecutive business days a majority of plan participants cannot obtain distributions or trade company stock held in the plan. ERISA §101, 29 U.S.C. §1021(h). The prohibition applies to any stock obtained by the director or officer in connection with his service or employment, whether or not held in the plan. The prohibition is meant to prevent company management from freezing trading in the company’s pension plan for ordinary employees while dumping their own stock during a decline in the company’s stock prices. Not only must the pension plan administrator notify plan participants (and the SEC) of the blackout, but the company must also notify directors and officers of the prohibition against trading in company stock. See Regulation BTR, Rule 104 (specifying contents and timing of notice).

Any trading profits realized by the director or officer during a trading blackout are recoverable by the company, regardless of intent—much like the strict liability scheme for short-swing profits under §16(b). See §24.3. The action to recover trading profits may be brought as a direct suit by the company or as a derivative suit by a shareholder after making demand on the company’s board. The suit must be brought within two years after the profits are realized. See Regulation BTR, Rule 103 (specifying “profit recoverable” to be difference between the transaction price and the average market price after the end of the blackout).

Unlike short-swing trading, which only triggers reporting requirements and the possibility of disgorgement in private litigation, trading during a pension plan blackout is *prohibited*. Thus, directors or officers who trade during such a blackout may also be subject to SEC enforcement actions and even criminal sanctions.

§23.4.2 Reimbursement (“Clawback”) of Incentive Pay When Financials Misstated

Sarbanes-Oxley “Clawback” Regime

Sarbanes-Oxley created a regime calling on corporate executives in public companies to reimburse the company for incentive pay when the company must restate its financials because of “misconduct.” Sarbanes-Oxley §304 (adding 15 U.S.C. §7243). Specifically, the CEO and CFO are required to reimburse the company for any incentive pay (such as bonuses or equity-based compensation) received from the company during the 12-month period after the misstated financials were issued or filed. This “reimbursement” duty also applies to any profits on the sale of company stock by the CEO or CFO during the same period.

The Sarbanes-Oxley reimbursement provisions sought to prevent a company’s top officers from profiting from false financials. The provisions, for which legislative history was scant, introduced numerous uncertainties: (1) Do voluntary restatements trigger a reimbursement duty? (2) What individuals are covered? (3) Are private actions (including derivative suits) available or only SEC enforcement? (4) Are negligent misstatements or only intentional ones considered misconduct? (5) How are trading profits calculated? (6) Can a company create its own definitions of misconduct and trading profits? (7) What is the statute of limitations?

There have been some answers to these questions, but only a few. Courts have uniformly interpreted §304 not to create a private cause of action, but only a basis for an SEC enforcement action. See *Neer v. Pelino*, 389 F. Supp.2d 648 (E.D. Pa. 2005) (plain language of Sarbanes-Oxley, buttressed by legislative history, precludes private right of action). The SEC, however, has brought few enforcement actions.

Dodd-Frank “Clawback” Regime

In response to the many weaknesses and unanswered questions of the §304 clawback regime, Dodd-Frank created a new one. Dodd-Frank §954. Under new §10D to the Exchange Act, the SEC is required to impose rules on the national stock exchanges that would compel listed companies to adopt “clawback” policies for the recovery of any incentive-based compensation (including stock options) from current or former executive officers for the prior three years in the event of a financial restatement due to material noncompliance with any financial reporting requirement under the securities laws. The amount to be recovered is set at the difference between the amount

of incentive-based compensation received and the amount that should have been received under the restated financial results.

The §954 regime of Dodd-Frank is different from the §304 regime of Sarbanes-Oxley. First, the new clawback right is enforceable, not just by the SEC, but also in derivative actions whenever companies fail to seek such relief. Further, private plaintiffs may initiate litigation even when restatements did not occur, but should have occurred were it not for a conflict of interest by management. Second, while the §304 regime only allowed disgorgement from the company's CEO and CFO, the §954 regime covers the company's current and former "executive officers," which presumably includes all officers subject to §16 reporting. Third, the §954 regime lowers the trigger for clawbacks to instances of "material noncompliance with applicable accounting principles," while the §304 regime was limited to restatements resulting from "misconduct." Fourth, the §954 regime extends the look-back period from one year to three years.

Despite adding greater clarity—and increasing the likelihood of enforcement—the §954 regime leaves some important questions unanswered. First, if an executive and the company's board fight the clawback, it is unclear whether the usual corporate law rules on board demand and dismissal of derivative litigation would apply. In particular, it is unclear whether the board (or a special litigation committee) could argue that the benefits of any clawback are outweighed by the disadvantages. Second, it is unclear whether the SEC and stock exchanges would have any leeway in defining such terms as "executive officers" and "material noncompliance." Finally, Dodd-Frank imposes no deadline for the SEC to issue rules to the stock exchanges or for the exchanges to pass the new clawback standards.

Examples

1. ITM Corp. is a publicly traded company with an active research and development department. Elbert, an ITM chemist, has conducted preliminary tests on a cobalt/phosphate film that electrolyzes (separates water into hydrogen and oxygen) at room temperatures. If the test results can be confirmed, it would be a huge scientific breakthrough with enormous commercial potential in storing energy generated by solar panels. Daniela, ITM's president, learns of the tests and sends an intraoffice memo to all concerned urging complete secrecy.
    a. ITM's board grants ITM stock to Daniela, who accepts. She does not

tell the board of Elbert's tests. Is Daniela liable to the corporation under Rule 10b-5?

   b. Daniela purchases "call" options (allowing her to buy ITM stock) on the options market. She does not trade with ITM shareholders. Is Daniela liable under Rule 10b-5?

   c. Elbert purchases ITM stock through a stockbroker under a written investment plan that calls for fixed, monthly purchases of ITM stock. Under the plan Elbert can choose to purchase more or fewer shares in any month, but he does not exercise this option. Is Elbert, who is neither a director nor officer of ITM, liable under Rule 10b-5?

2. After the test results are confirmed, but before public disclosure of the tests, Elbert tells Elsa (a fellow physicist who works for another research company) of the low-cost electrolysis breakthrough.

   a. Elsa buys ITM stock. Is she liable under Rule 10b-5?

   b. Elbert does not trade himself, but reveals the ITM test results to Elsa hoping to receive similar market-sensitive scoops from her. Assuming Elsa never reciprocates with information of her own, is Elbert liable under Rule 10b-5?

   c. Elbert and Elsa discuss the future of electrolysis and its impact on energy policy while riding in a limousine on their way to a scientific conference. Mickey, the limo driver, overhears their conversation and the next day purchases ITM stock. Is Mickey liable under Rule 10b-5?

3. Still before the electrolysis breakthrough is disclosed publicly, Daniela tells her husband Donald (from whom she is separated) that he should reconsider divorcing her since she stands to become wealthy because of a "top secret breakthrough" at ITM. She asks him to keep the information confidential.

   a. Instead, Donald buys ITM call options. Has he violated Rule 10b-5?

   b. Donald also tells a colleague at his office that "Daniela tells me there's a breakthrough at ITM—you should buy." The colleague does. Has the colleague violated Rule 10b-5?

   c. Donald and his good friend Martha have the same stockbroker, Merton. When Donald tells Merton to purchase ITM stock options,

Merton assumes Donald knows from Daniela that something good is afoot at ITM. He calls Martha and says simply, “Donald’s buying.” Martha buys ITM stock. Has she violated Rule 10b-5?

4. Meanwhile, at company headquarters Daniela receives a phone call from Raymond, a securities analyst who follows high-tech companies. Daniela tells Raymond, “There have been significant developments in our energy-storage research.” Daniela hopes to signal to the market the impending good news.
   a. Raymond tells his clients that ITM should be viewed as a “strong buy.” Has Daniela violated any duties?
   b. Daniela calls you, the company’s lawyer, and asks for your advice on how to handle disclosures about ITM’s electrolysis research and results to securities analysts. Can she talk with you, and what would you advise?
5. Before public disclosure of the electrolysis breakthrough, Daniela discloses it to Wilbur (the president of Third Federal Bank) to obtain a loan for ITM to build a new manufacturing plant. Daniela asks Wilbur to keep the information secret.
   a. Wilbur calls his stockbroker and buys ITM stock. Is Wilbur liable under Rule 10b-5?
   b. Wilbur tells his wife Wanda over dinner that ITM’s stock price is “probably going to go through the ceiling.” Wanda asks no more but buys ITM stock. Is Wilbur or Wanda liable under Rule 10b-5?
   c. Tina, a corporate spy, breaks into Third Federal’s offices and rifles the files to find the ITM loan application. She buys ITM stock. Is Tina liable under Rule 10b-5?
6. ITM’s board decides it should be prepared to add manufacturing capacity to produce electrolysis machines using the company’s cobalt/phosphate process. It decides to acquire Ovid Corporation, a publicly traded industrial builder, to build new manufacturing plants. ITM secretly negotiates an acquisition of Ovid.
   a. Before announcing the acquisition, ITM purchases a significant block of Ovid stock. Is ITM liable to Ovid shareholders under Rule 10b-5? Rule 14e-3?
   b. ITM decides to proceed with a tender offer, but before announcing

its bid the ITM board authorizes Daniela to purchase a limited amount of Ovid stock on the market. Is Daniela liable under Rule 10b-5? Rule 14e-3?

   c. Ovid shareholders who sold during the period between Daniela's trading and eventual disclosure of the merger sue Daniela to recover the gains they would have made if they had not sold. Is Daniela liable to these shareholders under Rule 10b-5?
   d. Daniela makes $100,000 in trading profits by buying Ovid stock. What is her maximum monetary exposure?
   e. Daniela attends a stock analysts' meeting, which is simulcast on the company's website. She announces that ITM will manufacture its new electrolysis machines, but does not mention new manufacturing plants or the pending acquisition of Ovid. One of the analysts, Tom, figures out that ITM is likely to acquire Ovid. Tom tells his clients, who buy Ovid stock. Is Tom liable under Rule 10b-5?

7. Legislation pending in Congress would create tax incentives for upgrades to the U.S. power grid, but does not extend the proposed incentives to utilities that switch their power transmission systems to new superconductive high-tension wires. A team of ITM executives meet privately with congressional leaders on the House and Senate committees considering the legislation. The executives receive assurances that Congress will include tax incentives for superconductive transmission systems.
   a. Senator Bills, who attended the meetings with the ITM executives, realizes that ITM's stock will go through the roof once the tax incentives kick in. He buys ITM stock. Is the Senator liable under Rule 10b-5?
   b. Senator Bills also realizes that it would be great if ITM's new manufacturing plants were built in his state. He calls the state governor and asks what kinds of incentives the state might offer to ITM to locate its plants in the state. After their chat, the governor realizes the potential for ITM and buys call options on ITM stock. Is the governor liable under Rule 10b-5?
   c. Legislative aide Sandro, who also attended the ITM meetings, receives a (regular) phone call from Mega-Data, a company that collects data of all sorts and sells the data to hedge funds for use in

their stock trading. Sandro reveals the basics of the meetings with ITM about adding tax incentives for superconductivity in the U.S. power grid. The hedge funds trade on this information. Are the hedge funds liable under Rule 10b-5? What about Mega-Data and Sandro?

Explanations

1. a. Yes, probably. Insider trading duties also apply to trading with one's corporation. As a corporate insider, Daniela has a fiduciary relationship to ITM and, under Rule 10b-5, a duty to abstain or disclose when trading *with the corporation* on the basis of material, nonpublic information. *Chiarella* (§23.3.1). An insider trading case under Rule 10b-5 must also satisfy the fraud elements of materiality and scienter:

   - *Materiality*. The information about the preliminary tests is material if a reasonable investor would consider it important to a buy-sell decision. Under the "probability plus magnitude" test of *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (§22.3.1), the magnitude of discovering a low-cost electrolysis process would be demonstrated by a post-disclosure jump in ITM's stock price. The probability that the preliminary tests would confirm the process's effectiveness seem high.
   - *Scienter*. Daniela knew of the tests when she accepted the options and should have been aware of their propensity to affect the value of the company's stock. See §22.3.2. It is not necessary that she actually used this information, but that she was aware of it. Rule 10b5-1.

   When trading involves nondisclosure, the Supreme Court has presumed reliance upon a showing that the undisclosed information was material. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (§22.3.3). In this face-to-face transaction, Daniela might nonetheless rebut the assumption of reliance by showing that the corporation (acting through an independent board) would have offered the options anyway, even had it known of the inside information.

   b. Yes, almost certainly. Daniela's abstain-or-disclose duty extends to shareholders and other investors in ITM's stock. *Chiarella* (§23.3.1). Does it extend to nonshareholder investors? Before 1984, some courts had held that option traders were owed no duty of disclosure. The

Insider Trading Sanctions Act of 1984, however, closed this judge-made loophole by explicitly prohibiting trading in any derivative instrument if trading in the underlying securities would violate insider trading rules. See Exchange Act §20(d).

Although materiality would seem an issue, it rarely is in insider trading cases. If the insider considered the information important to her buy-sell decision, it is almost certain that a court will conclude that a "reasonable shareholder" would also consider the information important—and thus material.

c. Probably, because the trading plan left some discretion to Elbert. The 10b-5 insider trading rules apply to any corporate insider with a fiduciary (or agency) relationship to the corporation. Elbert, an employee-agent of ITM, is subject to the same duties as Daniela. His awareness of the test results would establish a culpable state of mind, subject to an affirmative defense that the trading plan was such that the stock purchases would have happened regardless of his inside knowledge. Elbert would have to show he entered into the written plan before he was aware of the low-cost electrolysis breakthrough and the plan specified the terms of purchases, contained a formula for these terms, or disabled him from influencing the broker. Rule 10b5-1(c). That Elbert retained the option to increase or decrease the purchases each month means the plan was not fixed, as required by the SEC safe harbor rule for plan purchases.

2. a. Perhaps, depending on Elbert's motives and expectations. If Elsa knows (or has reason to know) that the information was confidential and came from an insider who tipped for some personal or reputational benefit, Elsa is liable as a tippee. *Dirks.* A significant issue is whether Elbert disclosed the breakthrough for personal gain or for some nonpersonal corporate reason. If he expected reciprocal stock-trading tips or personal reputational gain, the tip violated Rule 10b-5 if Elsa had reason to know those were his motives. If, however, Elbert revealed the breakthrough for business reasons, such as to discuss the scientific aspects of the discovery, Elsa is under no confidentiality obligation. Elsa's liability thus hinges on Elbert's motives—a deficiency of the *Dirks* approach, but part of federal insider trading law.

In addition to his motives, Elbert's expectations of confidentiality

might also be relevant. If Elsa and Elbert have exchanged confidential information in the past so that Elsa had reason to know that Elbert expected confidentiality, it might be argued she became a "temporary insider." In its recent Rule 10b5-2, the SEC has inferred a duty of trust and confidence in such circumstances. Although the rule by its terms applies only to misappropriation liability, its logic extends to identifying temporary insiders in cases of classic insider trading.

b. Yes. Elbert is liable as a tipper because he gave the tip in breach of his fiduciary duty for an improper personal benefit—the expectation of future reciprocal tips. Even though Elbert did not trade himself, a tipping insider is liable for placing confidential nonpublic material information in peril of abuse. *SEC v. Texas Gulf Sulphur* (see §23.2.1). Under this aiding and abetting theory, nontrading tippers are jointly and severally liable to the same extent as their trading tippees. See Exchange Act §20A(c).

c. Perhaps, though not as a tippee. If Elbert did not anticipate a personal gain from his discussion or there was an expectation of confidentiality, there was no breach of Elbert's duty and a tippee (or an eavesdropper) could not be liable on that basis.

Nonetheless, Mickey might be liable on a misappropriation theory. If Mickey worked for a limousine company that expected complete discretion of its employees, he could be liable for misappropriating the information in breach of *his employer's* expectation of confidentiality. See *United States v. O'Hagan* (§23.3.3). His trading would constitute a breach of duty owed to his employer if the employer expected that he would not divulge or use for personal purposes any information obtained on the job. The SEC confirmed this analysis by defining a relationship of "trust or confidence" to include a contractual relationship (though not necessarily creating a fiduciary relationship) in which there was an agreement of confidentiality. Rule 10b5-2(b).

One sticking point might be whether Mickey had the requisite state of mind. Although his awareness of the importance of the electrolysis breakthrough would appear to satisfy the general "awareness" standard for civil liability, see Rule 10b5-1(b), it may not be enough to establish the "willfulness" required for criminal liability. The *O'Hagan* court pointed out that under Exchange Act §32(a) a criminal 10b-5 defendant

cannot be imprisoned if he "has no knowledge of the rule."

3. a. Probably. The question is whether Donald is a "constructive insider" who has a duty of confidentiality because of his relationship to Daniela. Although earlier courts held that within a family duties not to trade on material, nonpublic information arise only if there were *express* understandings of confidentiality, recent courts have followed the lead of the SEC (see Rule 10b5-2) and treated spousal communications as carrying a duty of confidentiality if the spouses had an *express* or *implied* understanding of confidentiality. See *SEC v. Yun* (§23.3.3). By asking Donald to keep the information confidential, Daniela expected he would not use the information. Only if Donald could show her expectation was unfounded, perhaps because of his past indiscretions, would the presumption of spousal confidentiality be rebutted.

   Notice that this is not a case of tipping. When Daniela told Donald of the breakthrough it was not in the belief he would trade on it—in fact, she asked him to keep it confidential. Much like the spouse in *SEC v. Yun*, who told his wife during divorce discussions about an impending drop in the company's stock, Daniela's revelation was meant to preserve the marriage, not facilitate advantageous stock trading. Spousal communications about work do not constitute a fiduciary breach if the communications are not intended as a stock tip.

   b. Probably. The question here is whether the colleague is liable as a tippee. If Donald was a "constructive insider" (see previous answer), the issue becomes whether the colleague knew or had reason to know that Donald's tip violated his duty of confidentiality, which requires that Donald expected a personal benefit from the tip. See *SEC v. Musella*, 678 F. Supp. 1060 (S.D.N.Y. 1988) (holding two New York City police officers liable as tippees for receiving information from another officer, who had received it from an employee of a Wall Street law firm, on the grounds they "should have known" the original tip was a breach of fiduciary duty). Since the colleague knew that Donald had received the tip from Daniela, he should have (at the least) inquired whether Donald was expected to keep it secret. If the colleague had reason to know that Donald was not supposed to reveal the information, a personal benefit is virtually presumed—for example, it would be enough that Donald hoped for a good relationship with a workplace colleague. See *SEC v. Yun* (see §23.3.3). Courts have used the same

broad analysis as to what constitutes a "personal benefit" in cases of classic insider trading and misappropriation. If the tipper wrongfully tips the information and anticipates the tip will result in some financial or reputational gain (however slight)—and the tippee should know this—liability is established.

c. Perhaps not. This is much like the trading in which Martha Stewart was said to have engaged. Merely knowing that an insider is trading does not establish that he is trading on material, nonpublic information. That is, in the normal case there is no reason to believe that the trading breached a fiduciary duty. Unless the tipper—here, the broker Merton—told Martha that Donald was trading on the basis of specific inside information, it may be difficult to establish the tippee's requisite state of mind. Under Rule 10b-5, trading must be with scienter to be actionable in an administrative or private lawsuit (§22.3.2), and must be "willful" to be criminal. Exchange Act §32(a). Perhaps for this reason, the SEC only brought an administrative action against Stewart seeking fines and disgorgement of her insider trading profits. In 2006, she settled these charges without admitting or denying any wrongdoing for $195,000, representing a trebling of the losses avoided plus interest. The criminal case against her was based not on her trading, but on false statements she made to SEC investigators about her reasons for selling her stock.

4. a. Probably. Daniela has clearly violated Regulation FD if her disclosure of the electrolysis breakthrough was to only one securities analyst. Senior officials of publicly traded companies are obligated to disclose material information *simultaneously* to the market when the disclosure is intentional. Here Daniela had already warned others in the company to keep the electrolysis test results secret—suggesting she understood the information was material and nonpublic. Rule 101(a) (definition of intentional). There does not appear to be any effort to disclose the information to other analysts or investors. Nor does any exception apply since Raymond was under no duty to maintain the information in confidence.

Whether Daniela has violated the 10b-5 insider trading rules is not as clear. A violation of Regulation FD does not automatically create 10b-5 liability. Rule 102. And an argument can be made that Daniela is not liable under Rule 10b-5 since she was not a tipper under *Dirks.* She

disclosed the information not for any personal gain but to inform the securities markets. Nonetheless, one must wonder why she told only Raymond. If it was because he has given favorable reports on ITM in the past (boosting the value of Daniela's stock options) and Daniela expects similar favors from him in the future, her disclosure might have violated her *Dirks* duties. At the least, Daniela risks being the target of an SEC investigation.

b. Regulation FD forces companies to institute policies and procedures for dealing with market inquiries. Although conversations are permitted with company advisors, such as lawyers who have a duty of trust and confidence to the company client, senior company officials must be careful in disclosing material, nonpublic information to market professionals and investors who are likely to trade on the information.

- *Materiality determinations.* Companies should have policies for determining what information is nonpublic and material—such as earnings information, important product or contract developments, and important acquisitions or extraordinary transactions. There should also be procedures for consulting with inside counsel and, when appropriate, outside counsel.
- *Identify authorized officials.* Companies should limit analyst and investor contacts to specific company spokespersons—such as the CEO, the vice president of finance, and the head of investor relations. Private meetings or phone calls between senior officials and securities professionals should be discouraged, particularly if material information may be discussed.
- *Coordinated disclosure.* Companies should have procedures for responding to both informal and formal contacts. There should be internal communications channels so that questions are directed to the right persons and responses are consistent. For example, responses to common queries could be posted on a company intranet, and scripts for analyst conferences should be prepared and reviewed in advance. There should be policies for prompt "debriefing" of informal contacts to cure unauthorized disclosures.
- *Wide dissemination.* Material disclosures should be disseminated by press release and accompanied by the filing of a Form 8-K. Any press conference or analyst calls should be conducted on the Internet

to allow full media and investor access. These materials should also be archived for a set period, such as seven days. It may be useful to file a *procedural* Form 8-K to announce generally how the company will disseminate material, nonpublic information.

- *Forward-looking disclaimers.* Since many queries will ask for management's predictions and views about the future, the company should have policies for giving forward-looking statements that fit within the safe harbor rules. The speaker should identify the statement as predictive and refer the audience to risk disclosure in a readily available SEC filing. Exchange Act §21E(c)(2). These risk disclosures should be updated periodically.

5. a. Yes, under a misappropriation theory. Daniela provided Wilbur information on the electrolysis tests on the condition that the bank keep it confidential. Wilbur, in effect, misappropriated this information *from the bank.* If the bank had a policy against employees using confidential customer information—which seems nearly certain—he would be liable on a misappropriation theory. The theory protects confidential business information and assures stock trading markets that trading with information purloined in a relationship of trust and confidence is prohibited.

Even if the bank did not have this policy, the new SEC rule defining the relationships that trigger misappropriation liability specifies that if there was a pattern of sharing confidences so Wilbur had reason to know Daniela expected confidential treatment, Wilbur would have a duty not to trade. Rule 10b5-2(b)(2). Although the bank was not an agent of ITM, since commercial lenders typically deal with borrowers on an arm's-length basis, the SEC rule stretches the notion of trust and confidence beyond that of state agency law. Compare *United States v. Chestman* (see §23.3.3).

Notice, however, that Wilbur was not a tippee of ITM, since Daniela expected no personal gain from the disclosure and breached no duty when she provided it. She supplied the information so her company could get a loan, something permissible under the selective disclosure rules of Regulation FD. Rule 100(b)(2)(i).

b. Both are liable. Tipper and tippee liability work the same in an outsider misappropriation case as in an insider trading case. See *United States v.*

Falcone, 257 F.3d 226 (2d. Cir. 2001) (see §23.3.3—Tipping of Misappropriated Information). If, as discussed in the prior answer, Wilbur is under an abstain-or-disclose duty because of his position at the bank or his taking of confidential information, he cannot tip the information. Wanda is liable as a tippee if she knew (or had reason to know) that Wilbur received the information in confidence and that Wilbur gained some personal benefit (such as a share of her trading profits) by disclosing it to her. She is liable as tippee, and he as tipper, for any trading gains.

c. Perhaps not. Rule 10b-5 liability hinges on a relationship of trust and confidence, and there is none here. See *O'Hagan.* Tina does not have a relationship with and is not a fiduciary to either ITM or to Third Federal Bank. Nor has Tina agreed to maintain the information in confidence, nor is there any practice of sharing confidences with Tina from which an expectation of confidentiality might arise. See Rule 10b5-2(b). Although insider-trading prohibitions may be meant to protect confidential business information, it can be argued that 10b-5 liability is not so broad. Compare *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991) (liability of *former employee* who used magnetic identification card to gain access to secret information on pending takeovers).

Nonetheless, the Second Circuit has held that a computer hacker who illegally acquires a company's nonpublic information and trades on it for his own profit can be liable for insider trading, even though the hacker had no fiduciary relationship with the company or its shareholders. *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009) (holding that, despite lack of fiduciary relationship, "act of hacking" could satisfy 10b-5 deception requirement).

In any event, Tina can be liable for mail and wire fraud. See §23.3.3—Mail and Wire Fraud. In addition, if any of the information she stole and traded on related to a tender offer, she would also be liable under Rule 14e-3. See § 23.3.3—Rule 14e-3. Neither of these "information protection" rules requires a relationship of trust and confidence.

6. a. No. The trading does not breach any duty of trust and confidence. *Chiarella* and *O'Hagan* (§23.3.1). ITM has not misappropriated any information, since any proprietary interest in the information concerning the Ovid acquisition belonged to ITM. The company is merely

exploiting its informational advantage, based on its own plans, and has no abstain-or-disclose duty.

This analysis is the same under Rule 14e-3, which applies to material, nonpublic information about a pending tender offer. Even if the Ovid acquisition were structured as a tender offer, the rule applies only to persons other than the "offering person." Rule 14e-3(a).

b. Probably not under Rule 10b-5, though perhaps under Rule 14e-3. Because Daniela had permission to trade on information about ITM's undisclosed plans, she did not misappropriate any information when she traded in Ovid's shares. See *O'Hagan.* In these circumstances, there was no deception *aimed at the source of the information*, a necessary element for liability under the Supreme Court's theory for liability in *O'Hagan.* Just as ITM's trading on its own information would not violate Rule 10b-5 (see previous answer), Daniela's trading could be seen as a form of additional, indirect trading by ITM itself. There might, however, be problems for ITM under federal line-item disclosure rules (or state corporate fiduciary law) if the company fails to disclose this implicit executive compensation, but not under Rule 10b-5.

Whatever Daniela's authorization, she violated the terms of Rule 14e-3, which regulates trading on confidential information about a *tender offer*. See §23.3.3. The rule prohibits trading by "any other person" (besides the bidder) who possesses material, nonpublic information she knows is nonpublic and came from the bidder. Rule 14e-3. By its terms, Rule 14e-3 is violated even if there is no breach of a duty of trust and confidence. Does the SEC have the rulemaking power to regulate trading not in breach of a duty? Although the Supreme Court in *O'Hagan* upheld Rule 14e-3 as applied to a lawyer who had breached his duties by trading on confidential client information, the Court reserved "for another day" the legitimacy of Rule 14e-3 as applied to "warehousing," the practice by bidders of leaking advance information of tender offers to allies and encouraging them to purchase target stock before the bid is announced. Like warehousing, Daniela's authorized trading breaches no duty. As applied to Daniela, Rule 14e-3 may go beyond the SEC's rulemaking power.

c. No, even if Daniela violated Rule 10b-5, only shareholders who traded "contemporaneously" with Daniela can recover. The Insider Trading and Securities Fraud Enforcement Act of 1988 provides an explicit private right of action to contemporaneous traders against misappropriators. Exchange Act §20A. At one time courts saw the misappropriation theory as protecting the confidences of the outside company, here ITM, and held that Rule 10b-5 did not protect trading shareholders, such as Ovid's. The 1988 Act rejects this view. Liability, however, is not tied to the period during which the misappropriator failed to disclose, but rather the period of the misappropriator's trading.

d. There is no cap, if she violated Rule 10b-5 or 14e-3. Daniela can be liable for her trading profits in a disgorgement proceeding by the SEC or in a restitution suit by contemporaneous traders—maximum $100,000. See Exchange Act §20A. In addition, she can be liable for additional civil penalties of up to three times her trading profits—maximum $300,000. Exchange Act §21A. She can also be subject to criminal fines—now up to $5 million. Exchange Act §32(a). Finally, she can be liable for any losses to ITM if it had to pay more for the merger because of the signaling inherent in her trading—no maximum. All for a $100,000 trading gain!

e. No. Although Tom revealed nonpublic, confidential information to his clients (namely the likely ITM acquisition of Ovid), he ascertained it from public information and thus breached no duty. Nor did Tom have any duty to ITM (the source of the information) or Ovid (the company whose shares were traded).

But didn't Tom misappropriate information about ITM's likely merger with Ovid from his own brokerage firm? Although the brokerage firm could have used this information to its advantage, it is unlikely the firm has a policy against analysts disclosing their analysis to clients. In fact, Tom's job is probably to do precisely what he did. The Supreme Court in *Dirks* recognized the crucial role securities analysts play in disseminating information to the market.

7. a. Yes. Senator Bills violated his duty under the STOCK Act not to trade on material nonpublic information that he derived from his congressional position. See §22.2.3—Insider Trading by Members of Congress. Although there might be some difficulties for the SEC or

private plaintiffs to demand information about the meeting given the prerogative of members of Congress to conduct their business in privacy, there is nothing in the Constitution to suggest that Congress cannot regulate corrupt behavior by its members and staff.

b. Maybe. The state governor is not subject to the duties of the STOCK Act, but might be liable under Rule 10b-5 on four theories: (1) the governor violated his duties to his state by trading on information that he gained from performing his official responsibilities; (2) the governor had an understanding not to use confidential information from a federal congressional colleague; (3) the governor is a "temporary insider" with respect to the information from his federal colleague; and (4) the governor was a "tippee" who knew or should have known that Senator Bills violated his duties by disclosing this information for "personal gain."

The first theory depends on state law, which a federal court in a 10b-5 case might infer, just as federal courts have inferred the existence of fiduciary duties of trust and confidence in business corporations, even when state fiduciary law may not recognize such duties. For example, a state statute that mandates the confidentiality of state information would suggest that the governor violated a duty by trading on the basis of information he gained in his official capacity.

The second theory arises from Rule 10b5-2 and its creation of duties of trust and confidence in misappropriation cases when a person (here the governor) trades on the basis of information he agreed to keep confidential, or Senator Bills and the governor have an understanding that they expect their communications will be kept confidential. This expansion of Rule 10b-5 liability beyond fiduciary duties to the source (here the United States) has not been challenged, but would seem to be within the authority of the SEC under §10(b) to define the contours of a "manipulative or deceptive device or contrivance."

The third theory depends on a federal court using the logic of *Dirks* (see §22.2.1) to create "temporary insider" status for persons who have an agency-like relationship with the source of the information. Here it might be argued that the governor had become part of a "team" looking for ways to bring manufacturing to a state—and thus was duty bound to maintain the confidences of the group. That is, the governor assumed

the same duties as Senator Bills by acting as part of an initiative led by a federal legislator. That the STOCK Act creates only duties in federal legislators and their aides suggests that Congress did not go as far as *Dirks* did.

The fourth theory depends on Senator Bills having violated his duties by disclosing information about the ITM meeting. This theory seems less likely to succeed, given that Senator Bills was conducting legitimate official business when he talked with the governor about how his state might get ITM to build its manufacturing plants in the state. That is, it would not appear that Senator Bills derived a "personal benefit" when he shared this information. Although helping bring ITM manufacturing plants to the state might benefit him politically, Senator Bills seems to have shared the information with the governor to advance the state's interests, not his own. His actions would seem to be comparable to those of a company executive who legally discloses confidential information to advance a corporate interest, even while he might also benefit from any corporate success.

c. Each has probably violated Rule 10b-5. In this tipping case, liability for each person in the chain depends on Sandro having violated his duties of trust and confidence by "tipping" Mega-Data. There is no indication that part of his legislative duties includes disclosing information about private meetings between legislators and constituents. And although Sandro received no explicit personal benefit from Mega-Data, courts have accepted implicit benefits such as "personal friendship" and "professional connections." Here, if there was any possibility that Mega-Data would later offer Sandro employment (a "revolving door") or would give him any other favor, then Sandro would have received an improper personal benefit. Although in some situations congressional aides might be under instructions to "leak" confidential information for political purposes, there is no indication that the "owner" of the information (the Congress) asked Sandro to do this.

If Sandro breached his duties, then the next question becomes whether Mega-Data knew or should have known about this breach. Certainly, if Mega-Data had made direct promises to Sandro to obtain the information, it would be aware that Sandro's disclosure breached his duties. Even if Mega-Data did not make such promises, its recognition that the disclosure was about private meetings suggests that

it was not receiving the information as a member of the public—but as a special favor.

Finally, it seems likely that Mega-Data's hedge fund clients should have known that the information about private congressional meetings came from a source that violated his duties by disclosing the information. If Mega-Data told the hedge funds that Sandro was the source of the information, the funds should have known—particularly after the STOCK Act—that Sandro owed duties of trust and confidence as to market-sensitive information. Even if Mega-Data had not disclosed its source, the hedge funds should have expected that the information came from an inside congressional source and would have been under a duty to inquire further.

CHAPTER 24

Section 16(b)— Disgorgement of Short-Swing Profits

The prohibitions of Rule 10b-5 are not the only federal limitations on share liquidity. To deter price manipulation by insiders in public corporations and encourage insiders to acquire long-term interests in their corporations, Section 16 of the Securities Exchange Act of 1934 requires specified insiders to report their trading in their company's securities, and authorizes the corporation to recover from these insiders any profits made on stock purchases and sales in a narrow six-month period—so-called short-swing trading profits.

This chapter describes the companies, trading, and persons subject to §16 (§24.1), the trading reports required of specified insiders (§24.2), and the rules on disgorgement of short-swing profits (§24.3). The previous chapter dealt with the state and federal rules against insider trading.

§24.1 COVERAGE OF §16

Section 16 only applies to trading in the *equity securities* of a corporation that has a class of equity stock registered under §12 of the Exchange Act —*registered* companies (see §21.2.1). Thus, §16 applies to trading in any equity securities of registered companies, whether or not the particular securities are subject to §12 registration. For example, if a company's common stock is subject to Exchange Act registration, but its preferred stock

is not—because it is not listed on a stock exchange and is held by fewer than 500 shareholders (see §8.3.1)—trading by insiders in the unregistered preferred is subject to §16's reporting and disgorgement rules.

The SEC has broadened §16 coverage to include options, convertible securities, and other equity derivatives within the definition of "equity securities." Rule 16a-1(c), (d). Thus, insiders must also report their option trading and are subject to disgorgement of any profits on their short-swing option trading. The §16 short-swing trading provisions apply only to qualifying officers, directors, and shareholders who own (of record or beneficially) more than 10 percent of any class of the company's equity securities.

Exemptions for Executive Compensation

The SEC has created a complex set of rules that permit company executives to acquire and sell shares under company compensation plans. Recognizing the value of stock ownership in executive compensation plans, the SEC has exempted "tax conditioned" plans from the reporting rules and short-swing profit liability. These plans include those that are "qualified employee benefit plans" under the Internal Revenue Code (which allows tax deductions for the company and tax-deferral for the executive) and those that meet the requirements of a "qualified stock purchase plan" under the Internal Revenue Code. Rule 16b-3. This means that company executives need not worry about the short-swing trading rules when they (1) use plan contributions to acquire company stock or derivative securities, (2) purchase company stock in an employee stock ownership plan (ESOP), (3) dispose of company stock pursuant to domestic relation orders, or (4) receive distributions in company stock on death, disability, retirement, or termination. Company executives can even elect to transfer in and out of company stock funds, or receive cash withdrawals, if the election is made only once every six months.

Note on § 16(b) Effect on Corporate Governance

One effect of the §16(b) short-swing trading rules is to discourage shareholder activism—particularly by institutional shareholders. Taking a significant position in a company (more than 10 percent) or placing directors on the company's board limits the ability of activist

shareholders to buy and sell company shares during any six-month window. Section 16(b) is regularly cited as one of the reasons that U.S. institutional shareholders do not take a more activist role in their portfolio companies.

§24.2 REPORTS

To facilitate the policing of insiders' short-swing trading, §16(a) requires reports by qualifying officers, directors, and 10-percent shareholders. Form 3 (initial reporting once insider status achieved); Form 4 (reporting of subsequent changes in beneficial ownership); Form 5 (annual report).

The reports, which must be filed electronically with the SEC and posted on the company's website, disclose the amount of securities *beneficially owned* by the insider and the price paid in any purchase or sale. Initial reports must be filed within ten days after a person becomes an insider, and updating reports must be filed within two business days after any change in the insider's holdings. Rule 16a-3; Securities Act Rel. No. 8230 (2003). Failure to file subjects the insider to penalties.

§24.3 DISGORGING SHORT-SWING PROFITS — MECHANICAL TEST

Section 16(b) imposes automatic, strict liability on qualifying officers, directors, and 10-percent shareholders who make a profit (as defined) in short-swing transactions within a six-month period. No proof of intent or scienter is required. Recovery is to the corporation, and suit may be brought either by the corporation or by a shareholder in a derivative suit.

The mechanical short-swing profit rules are both overly broad and overly narrow. They broadly cover innocent short-swing trading that occurs without the use of inside information or any wrongful intent, yet they fail to cover abusive insider trading that occurs outside the six-month window or by those who are not insiders specified under §16.

Short-Swing Algorithm

A two-part algorithm determines whether disgorgement is available (the examples at the end of this chapter reveal the many permutations involved in determining §16(b) liability):

Identify a qualifying insider (whom the statute deems to have access to insider information and the power to manipulate the company's stock price).

- *Officer or director at either sale or purchase.* For qualifying officers or directors (but not 10-percent shareholders), official status at the time of either purchase or sale is sufficient—not necessarily both. The theory is that by trading when he was an officer or director, the insider had access to nonpublic information and was in a position to manipulate the price of the stock. Under Rule 16a-2, transactions occurring within six months before becoming a director or officer are not counted, though transactions occurring within six months of ceasing to be a director or officer are counted.
- *Shareholder (10 percent) "immediately before" both transactions.* For 10-percent shareholders, it is necessary that the person have held more than 10 percent *immediately before* both the purchase and sale to be matched. *Reliance Electric Co. v. Emerson Electric Co.,* 404 U.S. 418 (1972) (holding that shareholder must hold 10 percent or more before matching *sale*); *Foremost McKesson Inc. v. Provident Securities Co.,* 423 U.S. 232 (1976) (holding that shareholder must hold 10 percent or more before matching *purchase*). The different treatment of 10-percent shareholders comes from an exclusion in §16(b) of "any transaction where [the] beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved." The rationale is that 10-percent shareholders are less likely to have access to inside information or to corporate control mechanisms than officers or directors. Thus, their insider status must exist at both ends of the matching transactions.

Match any stock transactions by the insider that produce a profit. Section 16(b) liability is predicated on matching any *purchase* with any *sale* by a qualifying insider, regardless of order, that occurred during any six-month period in which the sale price was higher than the purchase price. There is no tracing of shares, and recovery is frequently measured by matching later lowest-cost purchases with earlier highest-cost sales. See *Smolowe v. Delendo Corp.,* 136 F.2d 231 (2d Cir. 1943) (establishing the "lowest price in, highest price out" method of calculating short-swing profits). There is no need to offset any losses—that is, any purchases and sales in which the sales price is *lower* than the purchase price need not be matched and can be disregarded.

Comparisons to Rule 10b-5

Section 16(b) is broader and narrower than the insider trading prohibitions of Rule 10b-5. Limited to trading in securities of registered companies during a six-month window, it is narrower than Rule 10b-5—which applies to all companies and regardless of holding periods. Yet, by covering any trading during a six-month period, whether or not based on inside information, §16(b) is also broader than Rule 10b-5—which requires a showing that

trading was based on material, nonpublic information.

§24.3.1 Special Interpretive Issues

The literal terms of §16(b) are inflexible, sometimes too harsh, and other times too lenient. To accomplish the rule's purpose to discourage manipulative insider trading, courts have interpreted the section's significant terms—*officer* and *director, beneficial ownership,* and *purchase* and *sale*—to introduce policy analysis into the otherwise mechanical disgorgement rules.

Officer and Directors

Courts have interpreted §16(b) to reach persons and entities who do not fall within the literal definition of *officer* or *director,* but who are functionally equivalent for purposes of insider access:

- **Functional officers.** For purposes of §16(b), a qualifying officer is any employee who has a position in the corporation that gives her access to confidential inside information that is not freely circulated. An official title may help identify these persons, but is not determinative. *Merrill, Lynch Pierce Fenner & Smith, Inc. v. Livingston,* 566 F.2d 1119 (9th Cir. 1978) (holding that a brokerage firm's "vice president" was not an officer for §16(b) purposes, because his title was merely honorary in recognition of sales accomplishments and did not reflect access to inside information). In 1991, as part of a comprehensive update of §16, the SEC defined "officer" to include those persons who perform policy-making functions. See Rule 16a-1(f) (definition based on title and policy-making functions).
- **Deputization.** Courts have developed a *deputization theory* for entities that hold stock in a corporation and are also represented on the corporation's board of directors. *Feder v. Martin Marietta Corp.,* 406 F.2d 260 (2d Cir. 1969). For example, suppose that Henrietta is a managing partner of Trout Brothers, an investment bank with a securities trading department, and that she also sits on the board of Bullseye Corporation, the subject of takeover speculation. If Trout Brothers purchases 5 percent of Bullseye's stock, §16(b) by its terms does not impose any short-swing trading liability: Trout Brothers is

neither a 10-percent shareholder nor a director, and Henrietta is not the beneficial owner of Bullseye stock held by Trout Brothers. Nonetheless, there should be concern that Trout Brothers will use Henrietta as its conduit of inside information.

Under the deputization theory, Henrietta is treated as Trout Brothers' "deputy" and any Trout Brothers transactions in Bullseye stock are subject to the short-swing profit rules. The scope of the deputization theory is unclear. Under one view, Trout Brothers is treated under §16(b) as a "director" if Henrietta (1) represents its interests on the Bullseye board and (2) actually passes along inside information to Trout Brothers. See *Blau v. Lehman*, 368 U.S. 403 (1962) (entire partnership not liable as an insider merely because one member was a director in a corporation in whose stock the partnership traded based on public information).

Beneficial Ownership

An important issue in many §16(b) cases is whether a person subject to the disgorgement rules beneficially owns securities that have been transacted. For example, if the spouse of an officer of Company X owns shares in the company, can transactions by the spouse be attributed to the officer? In 1991, the SEC promulgated a rule that defines beneficial ownership differently for 10-percent shareholders and officer/directors.

- **Ten-percent shareholders.** In general, beneficial ownership of securities under the Exchange Act depends on whether a shareholder has the power either to vote the securities or to dispose of them. Rule 13d-3(a). The SEC has adopted this definition for purposes of determining ownership by 10-percent shareholders. Rule 16a-1(a)(1). Under the SEC definition, this means that spouses and other family members (even if they share pecuniary benefits) are not the beneficial owners of each other's stock for §16(b) purposes unless they can control its voting or disposition.
- **Officers and directors.** Officers and directors are subject to a different rule of beneficial ownership that focuses on whether they have (or share) a "pecuniary interest" in the shares. Rule 16a-1(a)(2). The pecuniary interest can be direct or indirect, and does not depend on whether the

officer or director has any voting or disposition power over the shares. It is enough if the officer or director stands to profit directly or indirectly from the transaction. This means that if the spouse of an officer of a company sells her shares and the officer stands to profit indirectly, the sale is attributed to the officer.

Unorthodox Transactions (Purchases and Sales)

Usually whether a stock transaction constitutes a matchable purchase or sale under §16(b) is not an issue. But when the stock transaction is *unorthodox*—such as when shares are acquired in a merger or in an option transaction— the courts have been willing to inquire into whether the transaction should be treated as a matchable "sale" or "purchase" for purposes of §16(b). The SEC also has promulgated extensive (and very technical) rules that exempt certain transactions—such as redemptions, conversions, and transactions involving employee benefit plans—where the risk of insider abuse is minimal. Rules 16b-1 through 16b-11.

The Supreme Court has held that an unorthodox transaction by a hostile bidder (which became a 10-percent shareholder) in a takeover contest is not a matchable "sale" if there is no evidence of abuse of inside information. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973). In the case, Occidental successfully bid for 20 percent of Kern County's stock—a §16(b) "purchase." Concerned about Occidental's intentions, Kern County management found a white knight (Tenneco) that agreed to buy Kern County in a merger. Under the merger terms, "Old Kern" merged into a wholly owned Tenneco subsidiary and became "New Kern." Old Kern shareholders received Tenneco preferred stock in exchange for their stock. To buy Occidental's good will, Tenneco granted Occidental an option to sell its Tenneco preferred stock (after the merger) at a premium. Occidental agreed not to oppose or vote on the merger, and the remaining Old Kern shareholders approved. Occidental, along with the other Old Kern shareholders, then received Tenneco preferred stock for their Old Kern stock.

Was there a "sale" that could be matched with the tender offer "purchases"? The plaintiff argued there were two: (1) the option granted to Occidental—granted within six months of the original purchases, though exercisable after the six-month period; and (2) Occidental's exchange of New Kern stock for Tenneco preferred stock in the merger—which occurred within

the six-month period. In other contexts, the receipt of consideration in a merger has been treated as a sale under the federal securities laws. See Securities Act Rule 145 (requiring prospectus disclosure for securities issued in a merger). Nonetheless, the Supreme Court decided that Occidental had not "sold" its Old Kern stock in the merger because the transaction was involuntary and the relationship between Occidental and Kern County's management was hostile. Likewise, there was no evidence of abuse of inside information in the granting of the option, which was granted to buy Occidental's acquiescence in the merger.

But when it is possible inside information has been abused, the granting of an option has been treated as a "sale." In *Bershad v. McDonough,* 428 F.2d 693 (7th Cir. 1970), McDonough and his wife had purchased more than 10 percent of Cudahy's stock, and McDonough became a director. Within six months of these purchases, the McDonoughs granted another company, Smelting Refining, an option to purchase the bulk of their Cudahy stock. McDonough then resigned from Cudahy's board, and Smelting Refining placed its representatives on the board. Under the option agreement, the McDonoughs placed their Cudahy shares in escrow. Smelting Refining exercised the option more than six months after their original purchase. The court held that the granting of the option was a matchable "sale" because it could lend itself to inside speculation.

§24.3.2 Section 16(b) Litigation

Compared to the factual and legal issues that surround 10b-5 insider trading litigation, §16(b) short-swing disgorgement litigation is a cinch. The statute specifies the elements of a disgorgement action:

- realization of profit
- by an officer, director, or 10-percent shareholders
- from matching purchases and sales during any six-month period
- of equity securities of a public company

Suit by the corporation or by a shareholder in a derivative suit must be brought within two years of the date the profit was realized.

The information to establish a §16(b) disgorgement case is available in

public filings with the SEC. There is no requirement that the §16(b) plaintiff establish any of the elements normally required in a private 10b-5 insider-trading private action—namely that the trading was based on material, nonpublic information, that the defendant acted with a culpable state of mind, that those who traded relied in some way, that the trading caused any losses, or even that there were losses.

The only significant procedural issue in §16(b) disgorgement actions is whether the plaintiff has standing. Congress created a scheme of corporate enforcement and recovery. Under the statutes, if the corporation fails to sue within 60 days of a demand, an "owner of any security of the issuer" may bring a derivative suit on behalf of the corporation. The statute does not specify any standing requirements for a derivative suit plaintiff, and courts have interpreted the statute broadly to be consistent with its remedial purposes. Thus, some of the standing requirements in a normal derivative suit, such as contemporaneous ownership (see §18.3.2), do not apply in a §16(b) suit. See *Gollust v. Mendell*, 501 U.S. 115 (1991) (holding that shareholder of corporation acquired in a merger had standing to continue a §16(b) action against former 10-percent shareholder, even though corporation was merged into a new entity).

Why would a shareholder or bondholder bring a §16(b) disgorgement suit if any recovery goes to the corporation? The holder's interest in the suit is limited to the increase in value (if any) of the holder's securities. This diluted incentive, it would seem, will rarely justify investigating a §16(b) violation and initiating the litigation. The real incentive for §16(b) litigation is that the attorneys' fees of a successful derivative-suit plaintiff are recoverable from the corporation. It is no defense that the §16(b) litigation was brought primarily to obtain attorneys' fees. See *Magida v. Continental Can Co.*, 231 F.2d 843 (2d Cir. 1956).

Statute of Limitations

Section 16(b) suits—whether by the corporation or as a derivative suit—must be brought within two years of the date when the insider's profit was realized. §16(b). In 2012, the Supreme Court held that this period is not tolled if insiders have failed to file their §16(a) disclosures, though the Court did decide that traditional equitable tolling might apply. *Credit Suisse Securities (USA) LLC v. Simmonds*, 566 U.S. ___ (2012) (remanding §16(b) case, which had been brought in 2007 alleging short-swing profits arising during

dot-com boom of late 1990s, for a determination of when plaintiff, with due diligence, could have known or did know of trading at issue).

Examples

1. ITM Corp. has one class of common stock, which is registered under §12 of the Exchange Act. Dorothy is a director of ITM. For each of the following situations, what is Dorothy's disgorgement liability under §16(b)? Hint: you'll find it helpful to create a timeline for each sequence.
    a. Dorothy purchases 100 shares of ITM stock on February 1 at $10 per share, and sells on August 2 at $15 per share. ITM's stock price rose because it was awarded a large government contract on April 1, which Dorothy knew about when she bought.
    b. Dorothy buys 200 shares on July 1 at $5 per share, sells 200 shares on February 1 of the next year at $15 per share, and then purchases 300 shares on May 1 at $10 per share.
    c. Dorothy buys 100 shares at $10 per share on February 1, buys another 100 shares at $20 per share on March 1, sells 100 shares at $12 per share on April 1, and sells another 100 shares at $15 per share on May 1.
    d. Dorothy adds to her portfolio and buys 180 shares on February 1 at $10 per share, sells 150 shares on May 1 at $15 per share, and then sells another 100 shares at $18 per share on June 1.
    e. Dorothy became a director on March 1. Prior to this, on February 1, she had purchased 100 shares at $10 per share. She purchases 100 shares at $12 per share on April 1, and sells 100 shares at $15 per share on June 1.
    f. Dorothy purchases 100 shares at $10 per share on February 1. She becomes a director on March 1 and resigns as director on May 1. She sells 100 shares at $15 per share on May 2. Dorothy purchased in February at $10 per share knowing of confidential, nonpublic developments that would raise the price in May.
2. Cheryl is an investor with a keen interest in ITM. She is neither an officer nor a director of ITM.
    a. Over four years, Cheryl accumulates 9 million shares (9 percent) of ITM stock. On February 1 she buys 5 million additional shares at $15 per share, bringing her holdings to 14 percent. On May 1 she

sells all of her 14 million shares at $20 per share. What is Cheryl's §16(b) liability?

   b. After selling all of her ITM stock last year, Cheryl decides to acquire control of the company by making open-market purchases and a tender offer. She is prepared, however, to sell her holdings if another bidder offers a good price. Advise Cheryl on how to purchase and, if the opportunity presents itself, sell her stock without becoming subject to §16(b) liability.

3. Cheryl does not take your advice. Instead, she buys 11 percent of ITM's stock in December and then buys an additional 9 percent on March 1, bringing her holdings to 20 percent. She then enters into negotiations with ITM's management and, on July 20, agrees to have the corporation repurchase all of her stock.
   a. The repurchase agreement calls for closing on the repurchase to occur on October 1, outside the six-month window that opened on March 1. Under §16(b), can Cheryl's March purchases be matched with her July agreement?
   b. If the closing had occurred on August 1—at a slightly lower price than the one negotiated for the October 1 closing—does your answer change?
4. After selling back her shares, Cheryl and her husband Charles each begin buying ITM stock. By November, each owns 6 percent of ITM's stock.
   a. In January, Charles purchases additional shares at $40 per share, bringing his holdings to 9 percent. In March of the same year, Cheryl sells some of her shares at $45 per share, bringing her holdings to 3 percent. Is either liable under §16(b)?
   b. In August, after Cheryl and Charles sell all of their remaining ITM stock, Cheryl joins the ITM board of directors. She purchases ITM stock as trustee for her child's college fund. In November of the same year, Cheryl sells all of this stock at a profit. Is she liable under §16(b)?
5. MACO Corp. decides to "greenmail" ITM. To do this, it will first buy a large stake in ITM on the open market, then threaten a hostile tender offer, and finally negotiate a sale of its stake to ITM at a premium.
   a. Otto, an officer of MACO, sits on ITM's board. Is there a possibility of §16(b) liability in MACO's plans?

b. MACO has Otto resign from the ITM board. MACO then becomes a 10-percent shareholder in January and in February purchases 200,000 more shares. ITM management reacts by offering its shareholders a capital restructuring in which they will receive for their shares a package of cash and preferred stock. This will require an amendment to ITM's charter. MACO supports the restructuring, and its votes for the charter amendment prove decisive. After the June restructuring, MACO receives cash and preferred stock, producing a significant profit. Is MACO liable under §16(b)?

Explanations

1.a. No disgorgement liability. None of Dorothy's trades occurred within six months of each other. Under §16(b) it is irrelevant whether Dorothy had any material, nonpublic information about the government contract when she bought and sold. She may be liable, however, under Rule 10b-5 for insider trading (see §23.3).

Date	Transaction
February 1	Buy: 100 @ $10
April 1	Government contract
August 2	Sell: 100 @ $15

b. $1,000. Lower-priced purchases are matched with higher-priced sales occurring within six months. Only the February sale and May purchase can be matched; the July purchase is outside the six-month window. The disgorgement formula operates regardless of the order of the transactions as long as the sale price is higher than the purchase price. In this case, only 200 shares match, and Dorothy is liable to disgorge $1,000 in profits (200 shares times $5).

Date	Transaction
February 1	Sell: 200 @ $15
May 1	Buy: 300 @ $10

c. $500. Matching the February purchase and the May sale produces the highest gain—$500 (100 shares times $5). There is no need to offset any losses, so the $800 loss generated by matching the March purchase and the lower April sale can be disregarded. Even though Dorothy lost

a net $300 during the six-month trading period—she purchased 200 shares for $3,000 and sold 200 shares for $2,700—she is subject to disgorgement liability. This crude rule of thumb assumes that her February and May transactions were based on inside information or short-swing market manipulations.

Date	Transaction
February 1	Buy: 100 @ $10
March 1	Buy: 100 @ $20
April 1	Sell: 100 @ $12
May 1	Sell: 100 @ $15

d. $1,200. First match the transactions that produce the greatest gains (100 shares—February and June) and then any other transactions that produce gains (80 shares—February and May). The combined recoverable profits are thus $1,200 (100 times $8 profits, matching the $18 June sale and the $10 February purchase, *plus* 80 times $5 profits, matching the $15 May sale and the $10 February purchase).

Date	Transaction
February 1	Buy: 180 @ $10
May 1	Sell: 150 @ $15
June 1	Sell: 100 @ $18

e. $300. Although the February-June match produces a larger gain than the April-June gain, the February-June match is not available under §16(b) because Dorothy was not a director at the first point in the match—the February transaction. Under Rule 16a-2(a), transactions *prior* to a person becoming director are exempt from §16(b) liability. The idea is that she likely did not have had inside information when she bought in February. Matching the April and June transactions, Dorothy's liability is $300 (100 shares times $3).

Date	Transaction
February 1	Buy: 100 @ $10
March 1	Becomes director
April 1	Buy: 100 @ $12
June 1	Sell: 100 @ $15

f. No disgorgement liability. There is no sale and purchase to match because Dorothy was not a director at the time of either trade. Nonetheless, Dorothy may be liable under Rule 10b-5 for trading on

material, nonpublic information she received in her capacity as a director (see §23.3).

Date	Transaction
February 1	Buy: 100 @ $10
March 1	Becomes director
May 1	Resigns as director
May 2	Sell: 100 @ $15

2 .a. Cheryl is not liable under §16(b). The February purchase cannot be matched because Cheryl was not a 10-percent shareholder *immediately prior* to it. (In fact, Cheryl would not have disclosed her February purchase on Form 3 because at the time of the purchase she was not a 10-percent shareholder.) Shareholders must have "inside" status—that is, hold more than 10 percent of the shares—immediately before each transaction to be matched. This differs from the rule for officers and directors and is based on an assumption that shareholders are less likely to have access to inside information or the ability to manipulate prices.

Date	Transaction
February 1	Buy: 5MM @ $15
May 1	Sell: 14 MM @ $20

b. Cheryl should buy only 9.9 percent of ITM's outstanding shares on the open market. The purchase that brings her above 10 percent should be in one fell swoop—such as in a tender offer. In this way, none of her purchases will occur when she is a 10-percent shareholder, and none will be matchable. Cheryl can later sell without incurring any §16(b) liability. The assumption in *Kern County* (see §243.3), decided by the Supreme Court in 1973, that tender offer purchases that bring a shareholder's holdings above 10 percent are matchable was explicitly rejected by the Supreme Court in *Foremost McKesson* in 1976 (see §24.3).

If Cheryl makes any matchable purchases while a 10-percent shareholder, she should sell her stock in chunks, not all at once. In this way, only those sales that she makes while she is a 10-percent shareholder are matchable. Once her holdings fall to 10 percent or less, any further sales are not matchable. This limits her §16(b) exposure.

3.a. Probably not. Can the July 20 agreement be characterized as a "sale" for

purposes of §16(b)? Management's apparent hostility to Cheryl suggests she had no access to corporate information or control, and there would be little purpose in imposing short-swing liability. Such liability would effectively allow the corporation to renegotiate the repurchase price.

b. Probably. There would then be a traditional purchase and sale within six months. Nothing in the language of §16(b) suggests that there are exceptions to the disgorgement rules if the evidence strongly suggests the absence of inside abuse. Although the August closing would seem for financial purposes to be equivalent to an October closing, §16(b) may elevate the form of the transaction over its substance.

4. a. Probably not. The critical issue is whether Cheryl and Charles are treated as a single beneficial owner. If so, their individual 6 percent holdings would be combined. As beneficial owners of more than 10 percent, the January purchases by Charles would be matched with the March sales by Cheryl to produce a recoverable profit. In each case, they beneficially owned more than 10 percent immediately before the transaction. If, however, they are not the beneficial owner of the other's shares, neither can be liable because neither individually surpassed the 10-percent threshold.

According to the SEC, holdings of shareholders' percents must be aggregated if one shareholder has voting or disposition control over the other's shares. Rule 16a-1(a)(1) (for purposes of determining whether shareholders own more than 10 percent, look to investment/voting control rule). In this case, unless Charles or Cheryl had control over the other's shares, there would be no beneficial ownership. This is an unusual result, which essentially permits family members to hold and trade outside the strictures of §16 so long as no family member holds more than 10 percent of the company's stock and they do not enter into any arrangement to vote or dispose of the others' stock. Rule 13d-3(a). This means that even if Cheryl and Charles share the financial benefits of ownership, they are not deemed to be beneficial owners of each other's shares, making their January and March transactions unmatchable.

b. Probably. The question of beneficial ownership also arises for a director whose family members trade in the company's stock. See Exchange Act §16(a) (requiring reports of "all shares of which [the

officer/director] is a beneficial owner"). Normally, a director is subject to §16 for any trading by members of his immediate family. See Rule 16a-1(a)(2)(ii)(A) (defining "indirect pecuniary interest" in equity securities to include securities held by officer/director's "immediate family" sharing the same household). In §16(b) disgorgement actions, courts have attributed trading by a director's spouse to the director, treating profits realized as a result of the spouse's transactions as "profits realized by [the director]." See *Whiting v. Dow Chemical Co.,* 523 F.2d 680 (2d Cir. 1975).

In the case of securities held in trust for a family member, the SEC rules recognize the risk that a director may abuse her insider status in connection with the trading of securities as to which the director acts as trustee. See Rules 16a-1(a)(2), 16a-8(b)(2)(ii) (director who acts as a trustee is deemed to have "beneficial ownership" in trust securities if at least one beneficiary of the trust is a member of the director's immediate family). Nonetheless, some courts in §16(b) disgorgement cases have used a narrower understanding of beneficial interest than the SEC test. *CBI Industries, Inc. v. Horton*, 682 F.2d 643 (7th Cir. 1982) (Posner, J.) (director, acting as trustee for adult children, is subject to §16(b) liability for trading in trust only if director is able to use income or assets of trust).

This different treatment, apparently in sympathy for the trading limitations otherwise placed on family members of a director, seems questionable in light of the §16(b) purpose to discourage insiders from manipulating company stock prices to benefit their own trading. A director, it would seem, would have as much incentive to manipulate her company's stock prices whether profits flow directly to her or whether they flow to her children's trust fund. That is, consistent with the statute's broad remedial purposes, there are "profits realized [by the director]" when her trading decisions enhance her (and her family's) overall financial position.

5. a. Yes. MACO might be treated as a Bullseye director under a "deputization" theory because Otto, an officer of MACO, sits on Bullseye's board. If MACO is "deputized," any gains in its short-swing trading would be subject to §16(b) disgorgement.

To show deputization, Otto must have represented MACO on the

board. In addition, it might be necessary to show some (or all) of the following: Otto was "controlled" by MACO; Otto was ultimately responsible for deciding about MACO's acquisitions of Bullseye stock; Otto had access to inside Bullseye information; and Otto actually passed such information on to MACO. Although requiring a showing of actual access or actual passing of inside information might seem inconsistent with §16(b) strict liability, deputization is meant to achieve the underlying §16(b) purposes of deterring and compensating for the abuse of inside information. A deputization test requires a showing of actual or probable abuse.

b. Perhaps, though it is hard to say. Although the February and June transactions are matchable because MACO was a 10-percent shareholder before each one, it could be argued that the June transaction was not a "sale" for purposes of §16(b). Arguably, the June restructuring was involuntary—that is, its timing was not of MACO's making—and MACO's relationship to ITM was such that it is unlikely any confidential information was passed to MACO. See *Kern County* (§24.3.1).

There are, however, two significant differences between this case and the situation in *Kern County*. First, MACO supported the restructuring. This should not make a difference if MACO was not involved in ITM's restructuring decision and there was no passing of inside information. Second, ITM's management may have had reasons to pass inside information to MACO. It is possible that the restructuring was negotiated with MACO—just as was the option in *Kern County*. If so, ITM's management might have found it useful to pass inside information to MACO to ensure the success of the restructuring. Nonetheless, even if ITM passed inside information, it may well have been "good news" to encourage MACO's support. Because all the MACO shareholders shared in the restructuring premium, the abuse would not have harmed them.